

**THE IMPORTANCE OF KNOWLEDGE AND SKILLS TRANSFER
IN THE PRIVATE EQUITY, VENTURE CAPITAL AND ANGEL
INVESTING PROCESS.**

by

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Declaration

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Abstract

For any country, including South Africa, new business development is critical for the sustained growth and development of the economy. In this study the impact of the transfer of knowledge and skills by the investor to the investee and the impact on the success of private equity, venture capital and angel investments, new business development in South Africa and internationally is researched.

A literature study is firstly conducted to determine, from literature, the importance of the transfer of knowledge and skills by the investor to the investee of a new venture. The results from recent research conducted in the United States of America and Europe is also included to determine current global development tendencies. The research highlighted factors, other than merely having a good business idea, which determines the success of a new venture.

The global research clearly demonstrates that the active involvement of the angel investors, venture capitalists and private equity investors in new ventures, through the transfer of knowledge and skills, determines the success of the investment in new business development.

The survey that was done in the South African venture capital environment seems to support this outcome although the South African market sector is in the early stages of development and focuses mainly on private equity and not so much new business development.

Opsomming.

Nuwe besigheidsontwikkeling is krities vir enige land, ingeslote Suid Afrika, om deurlopende en volhoubare groei en ontwikkeling van die land se ekonomie te verseker. Hierdie studie het die impak van die oordrag van kennis en vaardighede op die sukses van privatekapitaal-, waagkapitaal- (alternatiewelik – nuwebesigheidsbeleggings) en engelbeleggings in nuwebesigheidsbeleggings vir Suid Afrika en Internasionaal, nagevors.

‘n Literatuurstudie om die belangrikheid van die oordrag van kennis en vaardighede, van die belegger na die nuwe besighede, in die gemelde beleggingsprosesse vir nuwebesigheidsbeleggings te bepaal, is eerstens gedoen. Die uitkoms van navorsings wat onlangs in die Verenigde State van Amerika en Europa gedoen is, is ook ingesluit om die huidige internasionale ontwikkelingstendense rakende nuwebesigheidsbeleggings te bepaal. Die navorsing het die klem geplaas op ander belangrike faktore anders as slegs ’n goeie besigheidsidee, wat die sukses van ’n nuwe besigheid bepaal.

Die internasionale navorsing het duidelik aangedui dat die aktiewe betrokkenheid van beleggers, engel-, waagkapitaal en privatebeleggers, deur die oordrag van kennis en vaardigheid aan die nuwe besigheid, die sukses van die nuwe besigheid en dus die belegging bepaal.

Die opname wat in Suid Afrika gedoen is, ondersteun hierdie internasionale bevinding alhoewel die Suid Afrikaanse nuwebesigheidsbeleggings sektor in die vroeë stadium van ontwikkeling is en daar hoofsaaklik gekonsentreer word op privatekapitaalbeleggings, “private equity investments”, terwyl die werklike nuwebesigheidsbeleggings nie soveel aandag geniet nie.

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CHAPTER 1 BACKGROUND AND INTRODUCTION

1.1 Background.

The creation of new ventures and businesses is determined for economical growth of any economy in the world. The entrepreneurial creativity to create new ventures and develop new markets enhances economical growth. Venture capital and angel investing are two of the most important facilitators of new business and job opportunities in the United States of America and the United Kingdom. David Birch established in the late 1970s that 70% of the job creation in the U.S. economy occurred in small business firms with fewer than 100 employees. Small business has a major impact on the American economy where more than half of the major innovations occur in small firms. (Bartlett, 1988: 11) The venture capital market is very active in the United States where billions of dollars are invested on an annual basis, and according to Schetler, (2006: 49), business angels alone invest over \$60 billion per year. Investors became cautious about the venture capital market after the collapse of the information technology bubble in the 1990s, but the subsequent withdrawal of funds were temporary and increasingly more funds are now available in the USA for investment.

The venture capital era began in earnest in America in 1946, after World War II, when General Georges Doriot, Ralph Flanders, Carl Compton and others organised American Research and Development (ARD), the first public corporation specialising in investing in illiquid securities of new business. General Doriot defined venture capital by categorising it in the following six points (Bartlett, 1988: 2):

- Involvement in new technology, new marketing concepts, and new product application possibilities.
- Significant, although not necessarily controlling, participation by the investor in the company's management.
- Investment in ventures staffed by people of outstanding competence and integrity.

- Product processes that have passed at least through the early prototype stage and are adequately protected by patents, copyrights and trade secret agreements.
- Situations which show promise to mature within a few years to the point of an initial public offering (IPO) or a sale of the entire company.
- Opportunities in which the venture capitalist could make a contribution beyond the capital dollars invested.

In Doriot's definition – the second and last point above – it is stated that the venture capital investor has a further responsibility over and above the money supplied. It is quite clear from the above definition that the intention of General Doriot was to have a hands-on involvement in the investments made. The venture capitalist in some instances and angel investors are normally wealthy individuals who have owned his own business and completed the venture development and investment process with success. The knowledge and skills thus acquired / earned in the process are essential for the success of any other new venture or investment made.

A definition by Benjamin and Margulis (2001: 7) defines venture capital as “the business of building businesses”. The definition defines a commitment to contribute more than money to the company. Venture investment involves building and financing successful self-sustaining companies. Investors should transfer their knowledge and skills to the investments made in order to increase the success rate of venture investment and reduce the risk thereof.

The type of venture capital investment in new enterprises changed over the years. It commenced some five hundred years ago when Spain's Queen Isabella financed the voyage of Columbus to the New World in 1496. Many new enterprises have since been financed by family members and friends or private investors believing in the entrepreneur's new venture. Venture capital was up to 1946 an investment on a personal basis. Doriot changed this practice with the creation of the ARD, but the element of personal involvement remained, as advocated by Doriot. The success of venture capital

investment and the high returns achieved by the investments attracted the attention of investment bankers in the early 1960. The investment bankers saw this as a good opportunity to increase their return on investments made. The amount of funds made available by the investment bankers removed the original venture capitalists, investing their own funds, from the market and replaced them with corporate investors.

The commitment to contribute more than money became difficult, since investors/fund managers are traditionally interested in a return on their investment and not in the management of the company. Venture capitalists started to select only investments where the entrepreneur already had the management team in place, as well as all the entrepreneurial and marketing skills. Venture capitalists moved away from small and early-stage investments to investments in companies in a later stage of development where the investment is much larger. The early-stage venture was left in the cold and many good investment opportunities were left in abeyance. This movement in the marketplace created the opportunity for individual venture capitalists to become involved in the market once again. These investors called themselves “angels” and they are very active in the investment market in America, where over 200 000 are registered, with many others not registered. Angel investors will be encountered, formalised or not formalised, in almost every country where venture capitalists are active. The original venture capitalists with previous experience in venture development, management and investment returned in the form of angel investors.

Hill and Power (2001: 1) define venture capital as follows: “Venture Capital Investing is all about the willingness to accept a high degree of risk in order to obtain the potential for an extremely high rate of return. Venture Capital Investing is all about a desire to build a small company into a large one, to build a company that no one has heard of into a company that makes headlines.” The change from Doriot’s definition to Hill and Power’s definition is quite clear. Venture capital changed from the business to create businesses to a money printing business. Capitalism does not fault the latter, but the risk profile of venture capital investments increased drastically. Venture capital is seen as a high-risk investment with very high returns if it is successful. In the South African context venture

capital is seen as a very risky form of investment not desirable as a normal investment instrument. There is, however, considerable need for these kinds of investments, since in the United States some 70% of all new job opportunities are created through venture capital or angel investment (Bartlett, 1988: 11). The near absence of this kind of investments and the development of these markets in South Africa shift the creation of job opportunities to multi-national corporations and the South African Government. The cost of job creation and business development is too expensive for the government and multi-national corporations to bear and, therefore, job creation and business development necessarily lag behind.

The change in the venture capital market and the involvement of corporate investors are not the only reasons why venture capital is seen to be a high-risk business. Entrepreneurs seem to have a high need for autonomy and power. One of the main characteristics of a typical entrepreneur is the drive to be independent and autonomous. Entrepreneurs believe that they do not need any nurturing by a mentor, and they want to, or have to, dominate the situation. They strive to be independent and “I know it all” is certainly one of the main contributors to the level of risk experienced in venture capital. In most cases the entrepreneur would have been involved with the project or concept for many months, or even years, he knows it inside out and also believes that he is the only one who is able to manage the process. Since entrepreneurs are human and only a few have the wide-ranging skills to develop, manage and market their enterprise, they sometimes become so focused on one dimension of the company that they neglect keeping track with what is happening in their wider company or the business environment at large. In this scenario the investor has a specific role to play in successfully launches the new product into the market, and building the new business to be a lucrative enterprise. Investors can add even more risk to the investment. Investors normally want to have control of the investment made. Control is achieved by taking control of the board of directors and the management team of the company. Investors typically change from being venture capitalists and angel investors to being “vulture capitalists” once their main objective is the maximising of the return on their investment whilst they ignore the wellbeing of the venture. In the short term they may well ignore the business, the people involved and also the long-term goals

and opportunities that may present themselves. A balance should thus be found between the short-term and long-term goals of the entrepreneur on the one hand and the investors on the other. The entrepreneur's creativity and drive should not be stifled, including the control and structure needed by the investor.

Over the years, and with the steady development of venture capital, venture capitalists and the corporate institutions developed criteria that a venture needed to fulfil before an investment would be made. One of these criteria is the company's management skills, which is undoubtedly one of the most important aspects of any business. Benjamin and Margulis (2001: 59) defined and discussed the risk aspects of a potential investment. According to them management is risk number one, and suggest that any investor should attend to the following questions before investing:

- Can management and personnel carry out the plan they so passionately present?
- Do they have the ability, experience, background, and track record to accomplish the forecast, sales and manage internal operations?
- Are they able to form a team within the ranks?
- Has any note of discord been struck among the members of the management team?

The above are crucial questions, and it would have been a perfect world if each small and medium enterprise (SME) could fulfil the above ideals. Practically this is not possible, and there are more SMEs lacking the above skills and knowledge than those that are equipped with these attributes. The question then remains: "How does one approach these investments and what should the role of the investor be?"

There are many more constraints, of which time is but one, in our modern economy and lifestyle, and the investor should bear these in mind. In a structured venture capital market the investors normally contribute to a venture capital fund, which invests in specific ventures after being evaluated. Bartlett (1999: 162) states that the partner in the venture capital pool would regard himself as someone with the expertise to add value to the investments under his control. He further states that: "The notion is that the typical founder, entrepreneur, is an incomplete businessman, with gaps in experience in matters

such as financial management and marketing”. The question remains: “Does the partner in the venture capital pool really participate or is he merely an investor/ banker with no intention to participate?” As asset managers took over the role of venture capitalists as the investors, it could well be asked whether they are “streetwise” enough to assist the entrepreneur, since they may be good fund managers, but lack any real business experience. The wording, partner, of the sentence quoted may be a contradiction since the investor has no intention to be involved in the venture or its development.

The need for a hands-on approach by investors is critical indeed. Carmelo Pistorio is a very successful Angel investor in Singapore with a hands-on approach. In the magazine, Red Herring of 20 April 2004, Anonymous D (2004: 1), it is stated that Singapore could be very fortunate that Carmelo Pistorio showed up there. “Mr Pistorio is something of a rare breed here; an angel investor with hand-on entrepreneurial experience to guide his seed companies. Money is not necessarily the hardest thing for a Singapore based start-up to come by, but experienced entrepreneurs to guide one along the bumpy road from concept to becoming a company seems rarer than hens’ teeth”. This approach made Pistorio a very successful investor, with a success rate much higher than that of the average venture capital fund. The above approach reduces the risk of venture capital or angel investment and can introduce venture capital and angel investment as an important investment vehicle in South Africa and many other countries.

The need for a hands-on approach and involvement is quite self evident in South Africa. This assertion is supported by a study by the Business School of the University of Cape Town, as reported by Ueckermann in the newspaper Rapport of 4 April 2004. The article stated that bureaucracy, limited training and insufficient access to finance as well as a lack of business knowledge and experience hamper the initiative of South African entrepreneurs (Ueckermann 2004). The South African Government has realised that there is a need in the market and that SMEs are able to play an important role in the creation of job opportunities and economic wealth. The South African Government consequently created the RED initiative (Real Enterprise Development) and introduced it to the market during 2004. This initiative aims at transferring management and entrepreneurial skills to

SMEs in order for them to create business, job opportunities and future economic growth (Bester, 2004), (Anonymous B, 2004) and (Anonymous C, 2004).

The SME sector is a segment in the South Africa economy that is for the most part financed by own or family funds, and the support from the financial sector is very slim, although its role is advocated. The creation of new enterprises and new inventions is a trademark of the South African economy and its people, but the financial support, transferring of management and entrepreneurial skills are lacking. SMEs are a very important job-creating sector in the economy that is otherwise being neglected. The development of this sector is directly linked to finances, managerial support and the transfer of entrepreneurial skills. The formal financial sector, commercial and merchant bankers, would support the investment activities in this sector once they have sufficient guarantees to cover their risk. The changing role of the commercial banking sector from business partner to risk avoiding financier, contributed to the SME sector trailing behind. The development of the South African venture capital market is in its infant stage compared to America and Europe, and concentrates to a large extent on the larger enterprises, leaving the smaller enterprises, normally with fewer than 100 employees, in the cold.

Professor William A Sahlman of the Harvard Business School summarised the background for his research proposal by stating that the monitoring oversight and advice (mentoring) that investors provide to their investee companies is an important element of financing of start-up companies. It is important to understand that investors provide more than mere capital to new firms, and that this added value is central to appreciating the importance of the private equity investor to our current economic development. (Benjamin and Margulis, 2001: 240). One should broaden this reference to private equity investments to include almost all new venture investments made. The risks of these investments could be drastically reduced, should management and entrepreneurial skills be transferred to the investments made. The real impact of the transfer of management and entrepreneurial skills to angel and venture capital investments should be researched to determine the effect of such a transfer on the success of these kinds of investments.

1.2 The Objectives of the Study.

1.2.1 The main objective of the study is to determine the impact of the transfer of knowledge and skills by the investor to the investee on the success of the private equity, venture capital and angel investments, internationally and in South Africa.

1.2.2 To achieve the main objective the following sub-objectives will be sought:

- To gather information from literature on any previous research done, or practical applications that exist, regarding the transfer of knowledge and skills to the investee.
- To determine by way of a survey the factors that determines the success of venture capital investments.
- To determine the possible impact of such a transfer of skills and knowledge success rate of ventures.
- To use the information collected to evaluate the South African situation regarding the transfer of knowledge and skill from the investor to the investee with the impact on the success of the venture capital investments made.

1.3 The Importance of the Study.

Venture capital investments and their success or lack thereof have been studied for many years. The USA is one of the countries where venture capital plays an important role in the creation of new ventures as well as providing jobs. A contradiction regarding the importance of the transfer of knowledge and skills by the investor to the investee was found in previous research results. Studies by Gorman, Sahlman, (1989: 242), Spienza, (1992: 22), Rosenstein, (1988: 167) as well as Maier and Walker, (1987: 209) have found that value is added. Some studies by Busenitz, Fiet and Moesel, (2003: 804), Macmillan and Kulow, (1989: 35), Rosenstein and Bruno, (1993: 99) as well as Barney, Busennitz and Others, (1996: 257) also found that little to no value would be added by the investor.

1.4 Research Methodology.

In the research methodology a clear distinction is made between the investor and the investee. The primary research in this study will comprise a survey of all companies involved in new ventures in South Africa.

The literature study is done to gather as much information as possible of any previous research done as well as any information available to satisfy the objective. The source of information is literature relating to the objective as well as previous research studies, articles written and any other available written material. The source of the literature study is books, magazine articles, newspapers, media reports and information available on the Internet. The literature study is further extended to include recent research done by Universities and venture capital organisations in the United States of America and Europe.

The purpose of the questionnaires is to gather information on the transfer of knowledge and skills as it relates to the objective of the study. Questionnaires were sent to angel investors, venture capitalists and private equity entities in South Africa. The quality and extent of the research done as well as the limitations mentioned in 1.5 below impacted on the South African survey. The population was chosen on a random basis. Specific respondents were also identified and included on the basis of their particular experience regarding the objective of the study. The questionnaire was sent out via electronic mail.

The purpose of the interviews was to gather qualitative information concerning the objective of the study. Interviews were conducted on a one to one basis, via telephone and the internet.

All the role players, the investor, venture capitalist, venture capital firms, angel investors, and investees, were included in the study to arrive at fair and correct findings. The measuring instrument used in the research is recent surveys done in the United States of America and the European Union compared with the South African survey questionnaire.

A clear distinction between the research results in the different categories is made to focus and add most value to the South African venture capital and angel investor's market.

1.5 Limitations.

The main limitation experienced relates to funding in order to do an extensive survey in all the countries where venture capital is practised. The study would benefit if one could study the transfer of skills and knowledge in each country and the specific application thereof. Complementary to the above limitation is the fact that all the venture capital organisations in all the different countries do extensive research each year in many different fields of the venture capital investment market, it is therefore not necessary to survey fields that are already thoroughly surveyed. The limitation of this approach is that a direct comparison between countries and their success rate in venture capital is not always possible.

1.6 Brief Overview of the Study.

1.6.1 Chapter 1. Introduction and background. The introduction and background provide a bird's eye view of the venture capital industry from inception to the current situation. Explaining the importance of the transfer of knowledge and skills, it concludes with the research methodology of the study as well as the limitations.

1.6.2 Chapter 2. Overview of the venture capital process, ownership and management. Chapter 2 will deal with the company and management structures as follows:

- A comprehensive background and overview of the role of the investor after the money has been invested;
- The board of directors' composition and the role and place of the advisory board in the investee company and briefly the ownership in the investee company;

- The role and function of the non-executive and external directors;
- The appointment and the role of the CEO of the investee company;
- An in-depth study of the role and appointment of the management team.

1.6.3 Chapter 3. Overview of the characteristics of the role players involved in venture capital. This chapter will deal with:

- The areas in which investors want to be involved and the areas in which entrepreneurs wish them to be involved;
- The reasons for success and failure of a venture, including what factors contribute to its failure or success;
- The relationship between entrepreneur versus venture capitalist;
- The role and place of the angel investors versus the venture capitalist;
- An investigation of knowledge management practices;
- Personality analysis of the entrepreneur and the venture capitalist with an indication of strong and weak points, and also areas of strength on which to build a relationship between the different parties, and
- An observation on the new wave, mentor capitalism and what is occurring in the venture capital market.

1.6.4 Chapter 4. Research in the United States of America and Europe. This chapter deals with:

- The selection of which countries to include in the research. It includes an evaluation to determine which countries have the largest venture capital activities in the world.
- The role of private equity and the misconception that private equity is venture capital and private equity investment.
- What is the origin of private equity funds and where do venture capital investors by implication raise their funds?

- In which stages of investment and in which industry sector do angel investors, venture capitalist and private equity prefer to invest?
- The performance of angel investors and venture capital investments are measured per stage of investment.
- The 2000 investment market's burst left lessons to be learned and these lessons are analysed, including the appearance of the funding gap in the venture funding process.

1.6.5 Chapter 5. Research design. Chapter 5 will deal with:

- The survey;
- The questionnaire;
- The research sample;
- Data collection .

1.6.6 Chapter 6. Data analysis and interpretation. This chapter will deal with:

- Instrumentation used;
- Process of analysing data;
- Analysing data;
- Interpretation of data gathered.

1.6.7 Chapter 7. Conclusions and recommendations for further research.

CHAPTER 2 OVERVIEW OF THE VENTURE CAPITAL PROCESS, OWNERSHIP AND MANAGEMENT

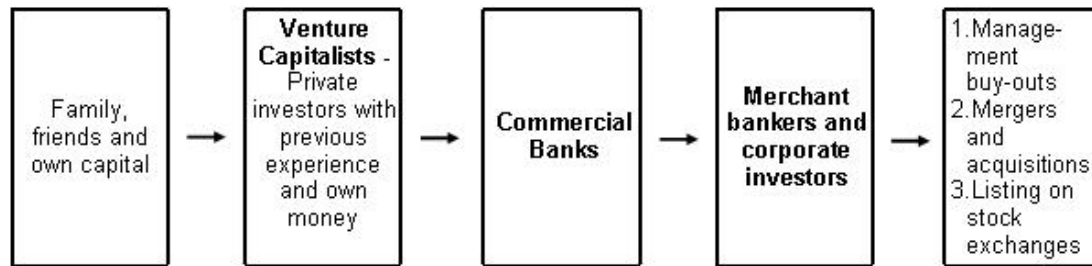
2.1 Introduction.

The investment, capital, skills and knowledge, in an entrepreneurial venture by venture capitalist, angel investors/ private investors and other investors plays an important role in the development and success of the venture (De Noble, Ehrlich and Moore, 1994: 69). This is the one aspect of venture capital investment that has been researched by many researchers. In addition many articles and books have been written on the subject. Numerous questions have been asked and scores of different answers have been given on the subject of value adding. The question that remains is: does the investor add value to the entrepreneurial firm and when does he add value?

There are different stages in an entrepreneurial firm's investment history. Investors fall into four categories according to Hill and Power (2001: 282) being (1) the investor's friends and family, (2) angel investors, vendors and professional advisors, (3) corporations are investing for the future and (4) venture capitalists. The commercial banks are not seen to be involved in the investment process, which was not always the case. Changes were introduced in the early 1960s when merchant bankers and corporate investors realised that the then venture capitalists were obtaining a higher return on their investment than they in turn could achieve. (Bartlett, 1988: 2) These markets became so interesting and lucrative that the merchant bankers and corporate investors too decided to become involved in venture capital financing. The involvement of these investors brought a great deal of capital into the venture capital market, but pushed the original venture capitalists (private investors) – with ample entrepreneurial and management skills derived from having their own companies – out of the market. The loss of these investors was later replaced when the “private investors” started to formalise their involvement again and such investment groups became known as “angel investors”. The details of the specific relationship between entrepreneur, angel investor and venture capitalist will be

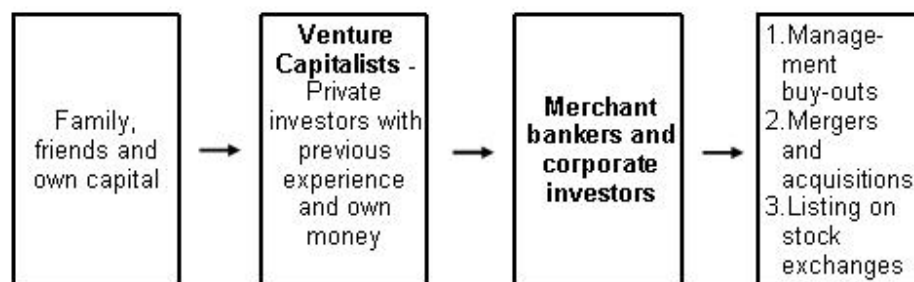
detailed later in this and the next chapter. Schematically one can explain the changes as follows:

Figure 2.1 Historical Phase.



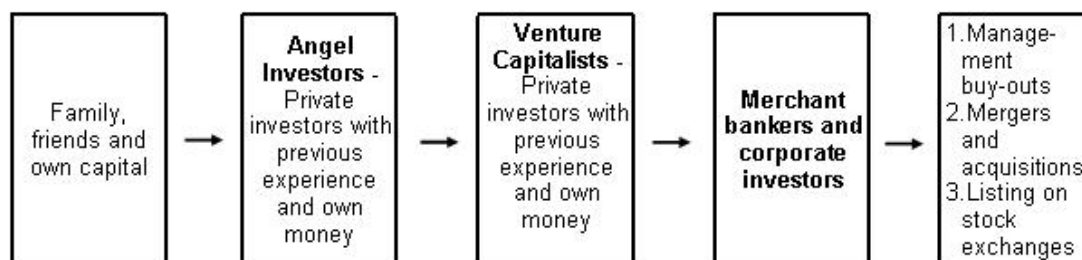
In this early phase the venture capitalists were the private investors who were or have been entrepreneurs with experience and knowledge, and have made a substantial amount of money and thereafter sold their businesses or wanted to further invest in business.

Figure 2.2 Middle Phase.



The merchant bankers and the corporate investors took over the role of the previous venture capitalist / private investor. The commercial banks also decided that this was not the market in which they wished to invest or lend to, because of the perceived risk and the unpredictability of their future. (Sorhiem, 2005: 178)

Figure 2.3 Current Phase.



The balance was restored with the introduction of the angel investors who now fulfil the role of the original venture capitalists. The angel investor plays an important role in the development of start-ups and small and medium enterprises. The venture capital firms and institutional investors do not prefer to invest in these ventures which form one of the most important investment sectors and where a large amount of investments are needed. (Van Osnabrugge and Robinson, 2000: 17), (Hill and Power, 2002: 222) and (Sorhiem, 2005: 178)

One of the most critical aspects in the investment process is to ensure that the venture capitalist, angel investor and entrepreneur evaluate and understand the implications of such an investment. In searching for capital, an overanxious entrepreneur may find that the long-term costs of the investment could far exceed the short-term benefits if there is a mismatch in expectations between the relevant parties. The source where the entrepreneur obtains his money is as important as the amount of investment funds received (De Noble, Ehrlich and Moore, 1994: 69). In addition to the investment the venture capitalist could provide a set of value added benefits that may evolve through interaction between investors and entrepreneurs (De Noble, Ehrlich and Moore, 1994: 70). The value adding concept should be evaluated from the investor's and the entrepreneur's perspective, since judging it from only one source creates problems, seeing that the parties may well have different expectations (De Noble, Ehrlich and Moore, 1994: 70).

An investigation by Macmillan and Kulow, (1989: 27), indicated that the venture capitalists are mainly involved in the financial management aspects of the venture and the lowest degree of involvement in the daily operating activities of the venture. An important way – other than financing and their interest in the financial aspects of the venture in which the venture capitalist contributes – is to serve on the board of directors of the venture. (Rosenstein and Bruno, 1993: 99) The three distinct levels of involvement adopted by venture capitalists, as identified by Macmillan and Kulow, (1989: 27), Rosenstein and Bruno, (1993: 101), De Noble, (1994: 70) as well as Benjamin and Margulis, (2001: 10), are:

- Laissez faire – limited involvement
- Moderate – moderate involvement
- Close tracker – active involvement. The venture capitalist has a very strong presence in all the activities of the venture.

Different strategies apply for each one of the levels of involvement with certain results pertaining because of the selections made. The venture capitalist, angel and entrepreneur should be sensitive to the specific needs of the venture and how their involvement is constituted. A balance between involvement, contributing to the venture's success, and running the company on a daily basis is an important function of the investor. Studies indicate that venture capitalists do not spend an inordinate amount of time directly involved with the management of their portfolio companies, intervening only on an *ad hoc* basis in the day to day operation of the companies. (Macmillan and Kulow, 1989: 27 to 28). Investors could become directly involved in a venture and some of these ways are (Macmillan and Kulow, 1989: 36):

- Assistance in finding and selecting key management team personnel
- Seeking essential suppliers and customers
- Strategic planning
- Assistance in obtaining additional financing
- Operational planning
- Replacement of management personnel when appropriate.

The specific areas of involvement and the importance of the involvement according to the investors and the entrepreneurs will be dealt with in detail in this research.

Assistance in obtaining additional financing is an important need of the entrepreneur. Start-up companies normally have low or negative cash flows which prevent them from borrowing or issuing equity (Grifford, 1997: 459). The new venture is further limited in its ability to acquire finance because of the lack of a track record and no financier would in all probability be willing to lend money to such a venture. Angel investors/ private

investors play an important role, combined with the venture capitalists, to solve this problem for the entrepreneur (Sorhiem, 2005: 178). The low or negative cash flow also prevents the entrepreneur to appoint a management team that would be adequate for the company and its expected growth. The venture capitalist can resolve the need for a complete management team with their involvement in the management of the company (Grifford, 1997: 459).

Venture capital and angel investing is popularly referred to as the business of building businesses where the investors will back the jockey (entrepreneur), and not the horse (venture/ idea). The right jockey, entrepreneur, needs to be part of the management team to ensure that the venture has a high probability to succeed. It is stated that it is better to have a good jockey and management team than an excellent idea/venture without an excellent jockey. Investors put money behind people, not just behind concepts or ventures. (Bartlett, 1999: 45 – 46), (Bartlett, 1988: 2.8), (Benjamin and Margulis, 2001: 59), (Hill and Power, 2002: 222) as well as (Wilmerding A, 2003: 134) There are many aspects influencing the venture capitalist's decision to invest or not of which the jockey is one of the most important aspects. The relevant aspects will be discussed later.

The investment in ventures goes hand in hand with the signing of contracts between the investor and the entrepreneur. These contracts normally have the following three main characteristics (Grifford, 1997: 459):

- Staging the commitment of capital and preserving the option to abandon.
- Using compensation systems directly to value creations.
- Preserving ways to force management to distribute investment proceeds.

These characteristics address three fundamental problems (Grifford, 1997: 459):

- Sorting the venture capitalist among the entrepreneurial ventures.
- Providing incentives to motivate venture capitalists to maximise the value of the funded ventures, and

- Providing incentives to motivate entrepreneurs to maximise the value of the ventures.

The main characteristics of the funding contract emphasise the importance and the role that the investor needs to play. It is quite clear that the investor is not only the provider of funding, but should share his knowledge and expertise with the investee. The involvement of investors reduces the risk profile of new venture investment and enhances the venture's chances of success. The success rate of entrepreneurial ventures is such that it is one of the main contributors to the creation of new jobs and the formation of new firms. (Bartlett, 1988: 11) and (Sorhiem, 2005: 178)

Venture capitalists are in the business to expand companies, but more importantly, to grow the return on their investment to maximise the profit for their shareholders or fund providers. The decision to withdraw the support of the venture capitalist may be taken because of a range of reasons of which the maximising of profit is possibly the most important. The venture capitalist will also try to increase the venture's size in order to increase profit. The principle remains that the magnitude of the profit versus the input needed has to provide the maximum output. A venture capitalist and private investor are only able to deal with a certain number of ventures and would attempt to maximise their time allocated versus income derived. Although the individual company may be economically viable, the return on time and capital to the venture capitalist may be less than the opportunity cost, in which case the investment will be terminated. (Grifford, 1997: 460) The maximisation of profit leads to the situation where the venture capitalist's main aim differs from that of the entrepreneur and will lead to conflict between the parties. In such an event the venture capitalist would merely become an "investor/ banker (finance provider)" whilst his mentoring role is put on the back-burner.

The transfer of skills and knowledge is crucial for the long term existence of any new venture and even of existing ventures with later stage investment requirements. The success rate of new ventures where the investors play an active role is much higher

than where no skills and knowledge transfer take place. In the remainder of this chapter and the next chapter it will be pointed out that the investor plays a very important role in the success of the venture. Venture capitalists are in the business of growing business, and not in the business to exploit entrepreneurs and become vulture capitalists instead of mentor capitalists.

2.2 The Composition of the Board of Directors and the Role of the Advisory Board.

2.2.1 Ownership.

Ownership in any venture is normally determined through predetermined rules and methods that are acceptable for the parties involved and which are most prevalent in the industry. The valuation of the venture/ business forms an integral part of the determination of the size of the investor's ownership. Ownership is not only determined through capital input, but also through the value added to the venture and entrepreneurship. Entrepreneurs were up to ten years ago convinced that they would have to relinquish control in order to obtain capital for their start-up or venture. The entrepreneurs never tied together the amount of capital requested, the valuation of the business and the amount of equity they would be giving up (Hill and Power, 2001: 39, 214).

Companies often have a number of rounds of financing during the cycle from start-up to a merger or initial public offering (IPO) that may be followed by a possible listing on a stock exchange. During this process the entrepreneur's initial portion of the total equity of his venture will shrink, although the total value of the equity will soar (Hill, and Power, 2001: 214, 243). The entrepreneur has to discount the growth in the value of the total equity against his reducing equity stake. Having 100% of nothing is much less than having a small percentage of something large.

The venture capitalist has to determine how much of the company the entrepreneur owns or will own after the investments are made. No entrepreneur would work hard for a

company where his equity stake is so small that he is virtually a hired employee. The investor should ensure that the entrepreneur always has a substantial stake in the company. Equity buys loyalty and determination. An entrepreneur's loyalty and determination normally fades if his equity stake is less than 20% in a small business and 5% in a large business. (Gladstone and Gladstone, 2004: 56). The flip side of the above is also true in that the smaller the equity stake and return on investment of the investor, the less time and effort the investor will be prepared to spend if he invests in the venture. Determining the ownership split is a very important aspect of any entrepreneur's preparation for negotiations with a prospective investor. Directors in venture capital backed companies are more involved in both strategy formation and evaluation than are boards where members do not have large ownership stakes. (Fried, Bruton and Hisrich, 1998: 493)

Professional investors take up ownership in ventures. Ownership is used as a method to discount risk through direct control and input. In order to control and monitor the investment, the venture capitalist typically serves on the board of directors of the venture. The board member representing the venture capitalist represents a major shareholder and should, therefore, have a significant influence on the day to day decision making. (Brunninge and Nordqvist, 2004: 90). The balance between ownership and the other risk reducing factors present is very important; the investor must allow the entrepreneur to maintain his drive, whilst the investor should feel comfortable that his risks have been covered.

Ownership is a balancing act between control, equity growth and the equity stake of the shareholders of the company. It is critical to ensure that the relationship between entrepreneur and the venture capitalist culminates in a beneficial situation where the company will have the best opportunity to succeed and the investor obtains the highest return on his investment. The size of ownership has to be equitable in terms of the investment made. The stage of investment will also influence the size of ownership as the return on the investment increases. Each time an investment is made, the shareholding will change. The size of shareholding is normally determined through the use of different

methods in the market. The most common is the net present value (NPV) method. If the venture capitalist for example invests R500 000.00 in a venture with a net asset value of R1 000 000.00, he will take up 50% of the venture if the net asset method is used. The net asset value will not be fair to the entrepreneur if the investor's expectation is an internal rate of return of 30%. The percentage ownership for the investor is determined to accommodate the investor's expectation. If the investor has a 30% return on investment expectation the shareholding, in the example in table 2.1, will be $(390.71/3907.06) = 10\%$.

Table 2.1 Investment Value.

Projected cash flow for the investment made.							
	NPV @ 6%	Year 0 (X R1000)	Year 1 (X R1000)	Year 2 (X R1000)	Year 3 (X R1000)	Year 4 (X R1000)	Year 5 (X R1000)
Total investment and cash flow after tax	3907	-1 000	500	1000	1250	1500	1750
IRR	83%						
Investors cash flow expectation per year	391	-500	175	193	212	233	256
IRR	30%						

The investor's ownership percentage will, therefore, be 10%, and not 50% as determined on the net asset value method. Exploiting the entrepreneur's lack of knowledge in negotiating and determining the correct shareholding stake for the investment made, could be detrimental to the success of the company when the entrepreneur realises that he has been deceived (Gladstone and Gladstone, 2004: 31, 39 and 56). To achieve the above, the venture capitalist should be prepared and be available to transfer his skills and knowledge to the entrepreneur and the entrepreneur needs to be open enough to accept these inputs in order to achieve the set goals and success. The role of the board of directors will be addressed next and forms a critical part in the success of any venture.

2.2.2 Board of Directors.

The board of directors of most venture capital-backed companies is the executive body of the company and it needs to take the critical business decisions. The legal function of a board of directors is to represent shareholders in the oversight of the management of the company, rather than to become involved in the day-to-day management. The role and activities of the board of directors will vary depending on the stage of investment (Camp, 2002: 58 to 60). The notion of investors is that the typical entrepreneur is an incomplete businessman, with gaps in his experience in fields like financial management, marketing, etc. An active board of directors, staffed by representatives of the investors, is expected to fill these gaps. Entrepreneurs are per se not always schooled to be managers/businessmen and it is significant, even in successful venture-backed companies, that a large percentage of the founders never see the company achieving maturity, since most of them will exit the venture beforehand (Bartlett, 1999: 23). Investors do not always have the same capacity to contribute equally. It is a fact that there is a wide range of experience among venture capital firms in the United States and wherever venture capital investment is established in terms of industry expertise, it contributes to business experience and the ability to contribute value. Investors can either add value beyond their money (smart money) or merely add money (dumb money). (Camp, Justin J. 2002: 64) It is also true and a golden rule that states: “He who has the gold makes the rules” (Bartlett, 1999: 96). The rule-making should never convert the venture capitalist into a vulture capitalist which would be detrimental to the venture and the investors.

2.2.3 Characteristics and the Role of the Board of Directors.

The board of directors should have certain characteristics to add optimum value to the enterprise. These characteristics are (Camp, 2002: 58 - 61):

- **Strong, Diverse and Balanced.** The quality of the board of directors should be very high. Early stage boards are typically composed of company founders, management team members, representatives of any venture capital investors or

angel investors and some outside directors (usually executives from established complementary companies in the same or related markets). Board members should have diverse and balanced skills, backgrounds, personalities, perspectives, appropriately experienced and well-connected. The engagement of an experienced businessman to sit in a key board seat will add great value to the company (Bartlett, 1988: 23). A homogeneous board should be avoided at all costs, as no new or growing venture needs one dimensional thinking. Such new companies need perspectives in diverse areas such as operations, finance, technology, marketing and consulting. A heterogeneous board should be controlled and orchestrated to achieve the maximum input and transfer of skills and knowledge.

- **Independence.** The board of directors of an enterprise should function independently. One of the most common mistakes by entrepreneurs is to stack their boards with members friendly to their cause. A board with too many representatives from management is far less effective than one composed of outside members. Costly mistakes could be avoided by having an independent board and discussing the company's business plan beforehand. Why should one redesign the wheel? It stands to reason that one should use the knowledge and skills available. Venture teams become so close that they think alike. New product ideas, strategies and directions could emerge as if from one mind, but the venture may well miss an opportunity if everybody agrees. A further reason for an independent board is to avoid irrational, unbiased appraisals of the performance of management teams. Without independence the directors will not be able to contribute objectively and effectively.
- **Attention and Intensity.** The directors of the company should have the ability to devote the appropriate time and attention to their professional duties. Too many companies view their board as window dressing and appoint people who may appear impressive on the letterhead, but who are not able to contribute much to the company. Early stage companies need all persons involved to pull their weight, directors included. A start-up company should select board members who

are able to spend the time necessary to learn about the company, its business, people, and products and to make a positive contribution to the success of the company and to detect danger signs as well as recognising opportunities.

The characteristics of the board of directors are determined in the success of the company. As intimated above, any board should be strong, diverse, balanced, and independent with the attention and intensity needed from the directors to achieve the ultimate success. Boards of directors will differ in the way they are composed to fulfil the variety of roles they may exercise. The different roles are: (Brunninge, Nordqvist and Mattias, 2004: 87)

- **Passive Role.** Merely to fulfil the legal requirements, one could have a board with no active involvement in the company. Normally the owners try to avoid interference in their management by board members. No contribution is made by the board.
- **Control Role.** Controls management on behalf of the owners, especially in larger firms.
- **Service Role.** Provider of advice and expertise to top management. Board members can help the managers accomplishing entrepreneurial activities and linking the company with important stakeholders in its environment. Boards with a service role allow the company to control important resources that are critical in entrepreneurial activities. The service role allows the venture capitalist to become part of the company and ultimately to become a mentor capitalist.

The preference of what role the board of directors should play is determined by the company and the shareholders of such a company. The service role complements the entrepreneurial activities of an early stage company the most, with the most value added. Value adding is a subject that has been researched substantively in the past with no definite finding whether in fact value is added or not. It is generally accepted that some

value is added, although it does not constitute an outstanding contribution (Rosenstein and Bruno, 1993: 100, 111)

Companies differently rate the notion of value added. The chief executive officers of companies that received funding from the top 20 venture capital firms in the United States rated the value of contribution by outside directors much higher than other CEOs of venture capital backed companies. In the same study it was found that there is no significant difference between value added by venture capitalists or outside directors. Board members with operating experience add more value than venture capitalists with less experience (Rosenstein and Bruno, 1993: 100). The areas where outside members have been of the greatest help, or made the biggest impact, are depicted in Table 2.2 below:

Table 2.2 Rating of Value Adding Activities.

ACTIVITY	RATING
Serving as a sounding board to the entrepreneur team	1
Interfacing with investor group	2
Monitoring operating performance	3
Monitoring financial performance	4
Recruitment and/or replacement of CEO	5
Assistance on short-term crisis/problems	6
Providing contacts with key customers and prospects	7
Development of new strategy to meet changing circumstances	8
Obtaining sources of debt financing	9
Obtaining sources of equity financing beside venture capital	10
Recruitment/replacement of members of the management team other than the CEO	11
Development of original strategy	12

Source: Rosenstein and Bruno, 1993: 106

The above study was done by Rosenstein and Bruno, (1993: 99 – 112) and is supported by studies by Macmillan, (1989: 27 – 47) and Spaienza and Timmons in 1988. There can be no doubt that outside directors or members from the venture capital firms do add value to the venture backed company. The reluctance of the entrepreneur to allow the venture capitalist on his board or the unwillingness of the venture capitalist to become involved in the target company may well contribute to the possible failure or slow growth of the company. The company's potential will be hampered by the failure of the company's management to involve outside directors on the board of directors. Many reasons may be established for their reluctance, but possibly the most common is their fear of losing

control. If any of the top 20 venture capital firms in the USA would become involved in the financing of a company, they would eventually most likely control the board (Rosenstein and Bruno, 1993: 100). In a study by Brunninge and Nordqvist, (2004: 85 and 98), it was found that non-family firms are more likely to involve independent board members than family firms. The presence of venture capitalists increases the frequency of independent board members and ownership has an impact on board roles (Brunninge and Nordqvist, 2004: 85). Family firms benefit from the presence of independent directors on their board in having more active boards than family firms without outside involvement (Brunninge and Nordqvist, 2004: 88). Family members could hamper the development of the company because of personal interest, lack of experience and many other factors. Conversely, the more independent people are appointed on the board of the family firm, the better. People lose their independence and creativity if they are caught in a family structure within a company. The background and competence of independent directors are essential if they are to contribute positively to the venture. (Brunninge and Nordqvist, 2004: 89)

2.2.4 The Size of the Board of Directors.

The size of board of directors could determine the effectiveness of the board and success of the company. Hence, the larger the board, the less cohesive the decision making and the more difficult it will be to achieve consensus in decision making. The lack of cohesion may occur as each board member grapples for power to maintain control of his own interests (Fiet and Busenitz, 1997: 352). The power game develops into a situation where self-interest is the most important factor that is attended to, and these actions will hamper the development and success of the company. Each shareholder starts to look after his own interests and the venture capitalist becomes a vulture-capitalist with nothing but the maximisation of the return of his investment as his main focus. (Rosenstein and Bruno, 1993: 99)

The boards of venture capital backed firms tend to be small with a high outsider ratio, with frequent meetings and a formal agenda. The boards increase in members as the

company grows or further investment is required. These findings were confirmed in subsequent studies. (Rosenstein and Bruno, 1993: 99 and 104) as well as (Brunninge and Nordqvist, 2004: 90) The optimal board structure and composition affects the company's performance in a positive way, such as increasing entrepreneurial capacity. Achieving the optimal structure and composition should be the ideal of every company's shareholder. (Brunninge and Nordqvist, 2004: 86)

Early stage boards are typically composed of company founders, management team members, representatives of venture capital and angel investors and some outside directors. The ideal board size is five directors, not too unwieldy that it is not manageable, but sizeable enough to include all the needed expertise. (Rosenstein and Bruno, 1993: 99) as well as (Camp, 2002: 59). The ideal board composition is (Camp, 2002: 59):

- Two investor directors
- One or two management directors
- One or two outside directors.

In a study by Rosenstein and Bruno, (1993: p104), it was found that the board size differs during different stages of investment. In this study the following board sizes were identified for the different stages:

Table 2.3 Board Size by Stage of Investment.

STAGE	BOARD SIZE
Seed	4
Start-up	5
First stage financing	6
Second stage financing	6
Third stage financing	6
Fourth stage, mezzanine and bridge financing	6

The success of the venture capital backed company is dependent on the quality and composition of the company's board of directors. In the later stages of the company's development, the management team will be able to perform some of the functions executed by the board of directors in the early stage companies. The contribution made by the board of directors is essential for the success of the venture. The composition, as indicated above, creates the opportunity for the transfer of skills and knowledge to the management team and other "new" directors on the board.

2.2.5 Advisory Board.

The board of directors is the legal board of the company, but in recent years early stage companies in the United States started to recruit experienced business persons to serve on an advisory board to those companies. The advisory board is not a legal entity, but a much looser association with no formal board meetings. The members of this board are individuals who agree to provide the company with a few hours consulting time per month (Hill and Power, 2002: 123). Darlene Mann, general partner of Onset Ventures, found in a study by her company that one of the major reasons why early stage companies fail is because of the lack of a mentor, in other words someone who has done it and who had been there before. Successful early stage companies usually have good advisory boards. These boards provide the early stage company with critical information

and help correct the direction of the company when needed. Angel investors and venture capitalists rather invest in companies with a strong advisory board than without one. (Camp, 2002: 62)

In composing the company's advisory board one should thus first determine the company's needs and management's shortcomings. The advisory board could help the company to fill in some gaps in the management team. Board members are able to provide any of the following, depending on the need (Hill and Power, 2002: 126):

- Contacts the company may need
- Specific competencies (financial management, marketing, etc.)
- General business success
- Knowledge of the industry.

The advisory board should not be composed of friends and family of one of the members of the management team or the chief executive officer. The board of directors should ensure that their advisory board have experience regarding (Hill and Power, 2002: 131 as well as Brunninge and Nordqvist, 2004: 87):

- Financing transactions
- Information technology consulting
- Extensive services focussed on e-commerce
- Seed financing to IPO (initial private offer)
- Mergers and acquisitions
- Tax planning
- Executive compensation strategies.

The advisory board could well form a critical element in the success of a venture capital backed company and the entrepreneur should exercise great care in compiling and selecting his advisory team. The advisory board's function is to provide the company with critically needed expertise and knowledge to ensure the success of the venture, and

the advisory board should act as a mentor to the management and board of directors of the company. The advisory board is an active team and not an instrument to impress someone else or a potential new investor. The company will reach success much earlier through the help of the advisory team than it would otherwise have done. (Hill and Power, 2002: 124 - 130)

The balancing act between the financing of a venture and the composition of the company structure is critical in the success of any new or later stage company. The venture capitalist or angel investor should ensure that his investment would provide to him the best possible return. Both the investor and entrepreneur should ensure that the venture is more important than personal goals and the need to control. Balancing ownership in such a way that the entrepreneur will not lose interest and the venture capitalist has equitable return on his investment through shareholding is very important. The entrepreneur should ensure that the venture's board of directors has the correct characteristics and understand the role it needs to play in the company. An advisory board should be recruited with the right skills and knowledge to empower the company's management and board of directors. From literature it is quite clear that venture capital backed firms need the transfer of skills and knowledge at this level of the company's structure.

2.3 Non-Executive and External Directors.

The role of non-executive directors (NED) or external directors is critical in the success of a new venture or start-up. A study done in the United Kingdom, the Cadbury Report (1992), emphasises how important the NED is and the role that the NED could play in any venture, especially new ventures. Since this report it became common in the UK that the larger firms appoint external directors to assist these companies to achieve their goals and ultimately help the economy grow. The Cadbury Report did not scrutinise smaller companies and, therefore, did not make any recommendations regarding such companies. (Deakins, O'Neil and Mileham, 2000: 318) The transfer of knowledge and skills is one of the pillars on which any venture can build its future, using the knowledge and skills

already earned to capitalise on and to build the enterprise. Consequently the recommendations and importance of NED also apply to smaller enterprises. Organisations never stop to learn. The firm and management team should always continue learning, while the capabilities of the firm and its management team and employees need to be increased to maintain their competitive advantage (Boussouara and Deakins, 2000: 210).

2.3.1 The Role of the Non-Executive Director.

It is generally expected that the NED will bring something to the table that would be valuable to the firm. Smaller firms cannot appoint all the expertise needed in their management team since the firm will not be able to sustain such a big cost. People with longstanding experience are not likely to join a firm and exclude themselves from becoming involved in other enterprises. The NED should bring certain skills to the table, for example they may be expected to bring experience, knowledge, discipline, rigour to strategic planning, contacts and planning skills. These are much needed knowledge and skills that could be transferred to the entrepreneur and his management team. (Deakins, O'Neill and Mileham, 2000: 317) The NED can fulfil many roles. The following are some of the most common roles:

- **Relationships.** The NED should be able to build a long-term relationship with the key or founding entrepreneur and bring his own network of contacts to assist in the growth process (Deakins, O'Neill and Mileham, 2000: 317). This intervention is crucial in the development and learning process of the entrepreneur and the company. The world is built on relationships, good relationships. Strained relationships can cost a company dearly, to the extent that the company may well fail or never reach its potential. Not every individual has the skill of building relationships. The ability to build long lasting relationships is dependant on the entrepreneur and his personality. An introvert entrepreneur may develop the best possible product, but may not succeed as regards the business venture because of his personality constraints.

- **Corporate Governance.** Any company operating within a set of laws should comply with various requirements, but early stage companies' management normally lack these skills. The NED could play an important role in assisting the company to comply with all these requirements without losing sight of the focus of the company. An entrepreneur's mind is not directed towards such thoughts as to whether he has completed the tax return or statutory reports that have to be submitted, including share transfers, appointment of directors and minutes of the last director's or annual general meeting of shareholders. Any non-compliance will be detrimental to the company's well-being and existence. Previous experience will empower the NED to assist the board of directors to comply with the above. (Deakins, O'Neill and Mileham, 2000: 318 and 319)
- **Mentor.** The NED provides advice to the entrepreneur and his team and through these actions becomes a mentor to the team. The concept of learning from experience and adjusting behaviour is important to entrepreneurship. (Deakins, O'Neill and Mileham, 2000: 318) One does not have to re-invent the wheel, with all the costs and pain involved. If the role of a NED could be summarised, it would be one of mentorship. This does not release the venture capitalist from his mentorship role, but would enhance the venture capitalist's and the entrepreneur's access to a pool of knowledge. The entrepreneur would prefer someone independent with entrepreneurial experience above someone from a large corporation with limited experience to advise him. (Boussouara and Deakins, 2000: 219) The entrepreneur will seek someone that has earned the knowledge and skills through first hand experience with the ability to transfer such knowledge and skills to the venture and its management team. Mentorship does not mean that one knows everything about everything, but rather that one knows a great deal about a subject or business and is prepared to share that knowledge and skills. A mentor should be "streetwise", although academic qualifications may equip him with some important building blocks,

it does not give the mentor practical experience. In research by Boussouara and Deakins, 2000 as well as Deakins, O'Neill and Mileham, 2000 it was found that the role of mentor and adviser was rated the most important by entrepreneurs. (Boussouara and Deakins, 2000: 215)

- **Credibility.** The NED could improve the credibility of a firm in new markets. The presence of a seasoned campaigner or a person who has been involved in the same market sector with positive results will comfort the new markets. (Deakins, O'Neill and Mileham, 2000: 319) Credibility and a good name are earned and not bought.
- **Independence of the Board.** Any board of directors should be independent and impartial, but it is a fact that most boards, especially those of family firms, are controlled by one or two persons, whilst the rest of the board is merely present in name. Historically, in the United Kingdom, an NED is appointed in family firms to bring some independence to the boardroom. (Deakins, O'Neill and Mileham, 2000: 320) The appointment of NEDs is not only limited to the United Kingdom, but is also prevalent in many other countries, such as South Africa, where this practise is often found.
- **Goals and Challenges.** Entrepreneurs may be expected to respond to challenges, yet the question of how to respond and overcome such challenges is an important part of their development. The NED sets achievable goals and challenges that would support entrepreneurial development. Through further support and encouragement the NED could ensure that the entrepreneur would overcome such challenges and to learn how to accommodate these challenges. Setting goals and challenges could be instrumental in the development of the entrepreneur's skills and knowledge. Guidance and support was rated the most important perceived action taken by external directors. (Table 2.4) (Boussouara and Deakins, 2000: 215) In the research by Deakins, O'Neill and Mileham, (2000: 322), an entrepreneur commented on the importance of

setting challenges as follows: “I think the most important thing of course is that it gives you somebody to challenge you, particularly in a small business when you are a fairly dominant part of it. It’s extremely important that someone challenges what you do and can actually argue with you”

- **Focus.** The truly independent NED has the advantage of providing the additional dimensions to director meetings that help to structure and maintain focus of such a meeting on strategic objectives and strategic planning. Personal relationships and company politics could divert the focus from the subject at hand and the directors' meeting could easily become an official forum to raise grievances, and totally ignoring the importance of the meeting for the company company as a whole. The NED needs to remain objective and skilfully help the team to focus on the company and its needs, whilst sidestepping personal differences and grievances. (Boussouara and Deakins. 2000: 219)

Table 2.4 sets out results of a study by Boussouara and Deakins (2000: 325) as well as Deakins, O'Neill and Mileham (2000: 215) ranking the importance of the different roles from the most to the least important.

Table 2.4 The External Director's Most and Least Important Perceived Roles.

ACTION	RANK ORDER
Most Important	
Guidance and support	1
Discussing problems	2
Constructive criticism	3
Discussing alternative solutions to problems	4
Using benefit of previous (general) experience	5
Least Important	
Ethical role/action	15
Relating concepts to practise	16
Visionary ideas	17
Succession planning	18
Restructuring board	19
Administration	20

The role as a mentor and sounding board is seen to be the most important role that the NED can fulfil (Barrow, 2001: 34). From his perspective the entrepreneur should be open enough to accept the advice and input from the external directors. Changing needs and growth of the entrepreneur and his management team affect the role of the NED and, therefore, the role of the NED is seen to be temporary. Once the company has outgrown the field of expertise of the NED, a new NED should be appointed to assist the company with new challenges. (Boussouara and Deakins, 2000: 220) as well as (Sheperd, Zacharckise and Buron, 2008: 381)

2.3.2 Trust.

Trust forms an integral element of any company's management and without trust the strength of a team diminishes. Trust becomes important because it enables co-operation to take place. Trust is a moderator in the behaviour that may occur in response to a crisis with four dimensions: competence, openness, concern and reliability (Boussouara and Deakins, 2000: 205). The best practical way to explain trust is to observe a team sport. The team members have to trust each other to the extent that no one would ever doubt the other players' commitment and ability. Each player knows that the whole team can rely and trust him to give his best and play to his ability. The secret of trust is to also be aware of the shortcomings of one's team mates and to compensate for that. The NED has to earn the trust of the rest of the team in order to contribute fully to the team. Strategic challenges are sometimes the direct result of a crisis affecting the survival of the company. The trust in the competence of the NED is paramount. (Boussouara and Deakins, 2000: 206)

Boussouara and Deakins (2000: 206 to 207) identified three functions of trust in implementing organisational learning. These functions are:

- **Trust as a Prerequisite.** When an external consultant is used to intervene and resolve a specific problem or situation that occurred in the company, the executives of the company should trust the ability and the intentions of the NED. The NED will operate as a mediator between the parties involved in resolving the specific situation.
- **Trust as an Outcome.** The relationship between company members should be at such a level that they would examine values and norms that shape behaviour, accepting new values to maximise the outcome.

- **Trust as an Obstacle.** Trust becomes an obstacle if an organisation's members have too much trust in an interventionist's competencies, and they become dependent on him.

In the abovementioned research it was found that boards of directors have all the characteristics of open systems where relationships and trust are paramount. (Boussouara and Deakins, 2000: 207) The transfer of knowledge and skills are dependent on trust, and where trust exists one would find the transfer of skills and knowledge to be much easier. Without trust one would only encounter limited transfer of skills and knowledge.

External directors' role in a company could range from being an informal sounding board to which full time board members could turn in times of need, through to helping with specific executive or operational functions. (Barrow, 2001: 34) Entrepreneurs have to learn how to assimilate and process information and knowledge, while operating in complex environments. External directors could bring considerable experience, which may be either specialist or general business experience. The role of the external director would differ from company to company, depending on the need and the trust present. The role of the external director in smaller firms could range from counsellor, entrepreneurial and growth strategic approaches to marketing, problem solving, strategic planning, recruitment, training and staff development. Companies will eventually outgrow specific external directors and would replace these directors as and when needed. The one characteristic that summarises the role of the external director is trust; without trust between the parties and in the abilities of each other no transfer of knowledge and skills would ultimately occur.

2.4 Chief Executive Officer (CEO).

One of the key ingredients of success of any venture is the presence of a strong and lasting CEO. A study by Crosspoint Venture Partners found that the only high correlation with the success of a business was the quality of the CEO. (Camp, 2002: 47) According to Dotzler and Camp, (2002: 47) it was found that:

- with a good CEO a company achieves,
- with an average CEO a company languishes, and
- with a poor CEO a company disappears.

The hiring of a CEO becomes one of the most important functions that the founders and the investors will perform upon inception. It is important for both the investors and for the founders that the company should achieve. Venture capitalists are known to get companies to agree to bring so-called “adult supervision” (seasoned managerial talent) into the company before they would invest (Camp, 2002: 31). A study by Bruton in 1997 found that the replacement of a CEO improves the performance of the company (Busenitz, Fiet and Moesel, 2003: 793). This finding could be challenged and this occurrence would also not be applicable to all companies, as there are many other influencing aspects that come into play.

The performance of a company will only increase if the right CEO is chosen for the position. The selection of the right CEO can be a time consuming and tedious process. The Woodside Fund treated this aspect as so important that it interviewed 22 candidates for a CEO position in one of its portfolio companies. Naresh Baresh, CEO of Intellefex, one of Woodside’s portfolio companies, said after the interviews that he was mentally and physically drained, but Woodside appointed the rest of the management team with the same care. (Anonymous A, 2005: 40 – 43)

The selection process is not an easy one, since one of the major problems is that the typical entrepreneur has a resistance towards sharing control (Macmillan and Kulow, 1989: 39). The battle between the investor and the entrepreneur and the investor’s need to have “adult supervision” and the need of the entrepreneur to keep the control of the company has to be addressed with insight and knowledge of the situation. The company always has to be more important than the individual and his needs. One of the most intriguing questions is whether or not the entrepreneur would be willing to step aside for a new CEO in order to allow the new, qualified, CEO to run his company (Hill and Power, 2001: 43). To step down from his position may be as painful for the entrepreneur

as to ask a mother to part from her new born baby. The fact of the matter is that the entrepreneur may, in most cases, not be equipped to be the CEO. The entrepreneur and the seasoned CEO should be able to treat the company as the most important entity for which they have ever worked. The new CEO of the company should ensure that he transfers his knowledge and skills to the management team to empower them.

Contrary to the belief that seasoned/grey hair people add value to the company, this may in fact not be the case. Some retired CEOs may well have a preference for attaching themselves to inexperienced entrepreneurs with the aim to slowly taking over the business. The aim of the above described CEOs is to add value to their pockets and not to the business in which they are involved. This kind of selection or presence of a CEO may give the entrepreneur the impression that he is still in control, merely to be sidelined once the time is deemed right. (Hill and Power, 2001: 170)

The CEO does have an important role in the success of the company. The shareholders and investor have to ensure that the CEO has applicable experience in the same industry (Camp, 2002: 43). Good CEOs come in all shapes and sizes. There is not a single model that fits all to select the perfect CEO, although there are essential skills that should be present. These skills are (Camp, 2002: 47 – 50):

- **Experience.** Experience in the same industry as well as previous experience as a CEO has a positive effect on the success of a venture. History shows that experienced CEOs tend to be more successful than those with little to no experience in this position. It should also be said that many first time CEOs have been very successful. The experience of the CEO will always remain a critical factor in the success of a venture.
- **Leadership Ability.** The CEO should have the ability to lead the company from a start-up to a listing or a merger. A start-up needs a strong leader, someone who has the ability to lead, manage and motivate the entire company. It takes a good leader to get the whole company to work together and hard enough to

achieve the goals of the company. The CEO should have the experience to know what to do when and how to handle difficult situations. Venture capitalists would, therefore, only back companies if the CEO has previous experience in running a company or division of a company. No investor would back a novice CEO, even if he has a great deal of leadership abilities. Often the most popular CEO candidates, among venture capitalists, emerge from the executive ranks of larger, proven companies. It is crucial that the CEO should be streetwise in order to add the most value to the company.

- **Strong Communication Skills.** A CEO needs to have the ability to communicate. He should be a great communicator seeing that he is the face of and the leader of the company. The CEO must be able to communicate clearly, both in speech and writing to the media, customers, peers, the public and the employees of the company. The CEO should also be able to sell the company to investors, shareholders, employees and clients. The vision of the CEO has to be shared with everybody involved. If everyone shares the CEO's vision, the team will be cohesive in achieving the vision.
- **Decision Making Ability.** The role of the CEO in a start-up and even in a later stage company is to make decisions. More and more decisions have to be taken as the company grows. The CEO must have the ability to assess the situation and the facts, weigh the facts and make the best possible decision. CEOs with the ability to make strategic correct decisions are very sought after. Another characteristic is the ability not only to assess the facts, but also to evaluate the impact of decisions on the company and the environment. Therefore, making strategic decisions is of the utmost importance. The ability to make quick decisions is equally important. It is stated by Ruthann Quindlen in Camp, (2002: 49) that it is better to make the wrong decision, than no decision at all. A CEO who cannot make decisions will lose the trust of the owners, employees and the management of the company.

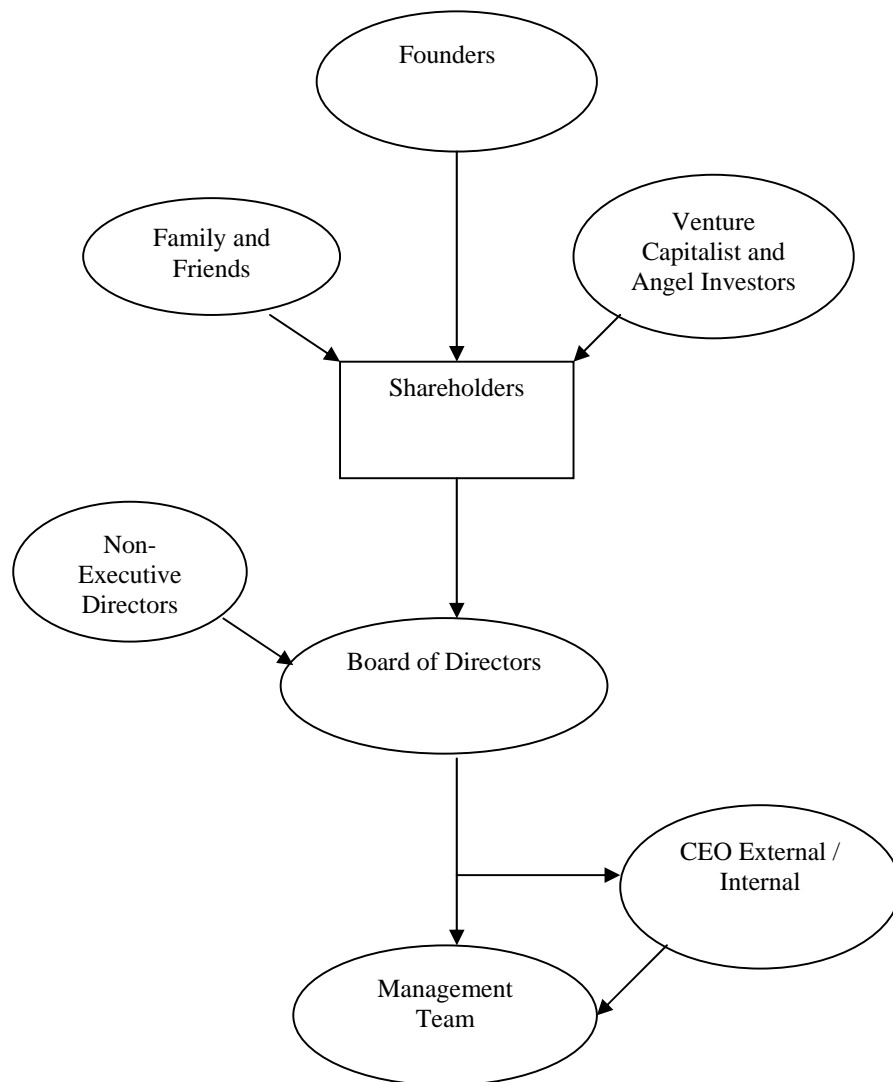
- **Administrative Skills.** Great CEOs are able to effectively manage their companies from an administrative perspective. Entrepreneurs are normally people that have a limited administrative ability. No company is able to exist in today's competitive environment if the administration is not kept up to date. These skills entail personal management, statutory management, contract management, intellectual property management and general administration management. In most early stage companies the administration management is left for someone to sort out in future. A company without a good administrative base is like a house without a foundation.
- **People Management Skills.** A CEO has to have the ability to work and combine different people with different personalities, into one team. This aspect incorporates more than mere leadership; it is the ability to communicate effectively with investors, the management team and the employees of the company. The CEO should be involved on a level where he adds value by transferring his skills and knowledge to the management team to improve the management team's management skills and to be able to get the entrepreneurs, investors and management team to work together as a team. The success of the venture is dependent on this ability of the CEO.

In conclusion, it may be stated that the role of the CEO is critical for the success of the company and to ensure the highest return on the investor's investment. The founders are more than likely entrepreneurs and not managers or CEOs who have to be convinced that a seasoned CEO or a CEO under supervision should manage the venture. The investors/venture capitalists and the founders have to ensure that they appoint someone with the ability to add value to the company. In the process of selecting the right CEO one should ensure that the CEO has the skills as specified in this section. Selecting a CEO without these skills will be detrimental to the venture.

2.5 Management.

The management team is seen to be one of the most important aspects that influence the success of a venture. Hill and Power, (2001: 106) stated that the single most important action that an entrepreneur takes that would determine success, is his ability to assemble the right team around him. One could regard the shareholders and directors of a company as the head of the company, but the management team forms the heart of a company. The management team determines the effectiveness and quality of the execution of the business plan; they are the people that link with the outside world, but will also execute the plans inside the company. Schematically a company's structure could be sketched as in Figure 2.4:

Figure 2.4 Company Structure.



Founders (entrepreneurs) would in most cases wish to be the Chief Executive Officer of the venture, since it is his idea and metaphorically speaking he gave birth to this baby. Control is essential for most entrepreneurs, although they would most likely not be the best managers. An entrepreneur is a creative person who would like to concentrate on new ideas and inventions, but he would typically neglect to pay attention to the detail that is essential for the success of the venture. Nearly all investment decisions by venture capitalists and angel investors are made based on the investor's belief that the

management team can capably execute their business plan (Blanchard, 2006: 1 - 3). Early stage companies rarely have complete management teams, ready to manage from day one without assistance. Such companies often have to search elsewhere for management support at the board of directors, the board of advisors/ non-executive directors and their equity investors (Camp, 2002: 23). The founders should accept that they are not necessarily the best managers to ensure the success of the company and should consequently open up the process of appointing outside managers. The acceptance should emanate from the founders to realise that the company is more important than personal ego and that one should be open enough to appoint the best team in order to achieve success. The success of obtaining finance depends on the perceived competence of the management team. There is an old expression that a great management team and a run of the mill idea get funded more often than a great idea and an average management team. (Hill and Power, 2002: 134)

Venture capitalists, more so than private investors or angel investors, search for investments with the least personal input to be made. They will look for investments with complete, or close to complete management teams. Many good ideas and ventures are ignored or discarded because the venture capitalist will go the route that is perceived as the safest route to take. It is clear that a good management team is more important than the idea. (Hill and Dee, 2001: 50) The entrepreneur who is not aware of this fact may well never see his ideas reach maturity. Private investors play an important role in assisting the entrepreneur to accept these facts. The private investor initiates the process and assists the entrepreneur in preparing his company for further finance. The entrepreneur has to be prepared to stand back and allow professional managers to manage the company, while the entrepreneur concentrates on the further development of his idea and further innovations. The different role players should focus on what they are good at, which in itself is a good point of departure for achieving success.

Accepting the mere fact by the entrepreneur that he may not be the best manager, is a major achievement, simultaneously addressing the appointment and dismissal of a management team, as well as the role of the management team and the investors in the

management of the company. In what follows these aspects will be addressed, including the ability of the entrepreneur and the management team to work together as one, a critical aspect in achieving success. (Macmillan and Kulow, 1989: 40)

2.5.1 Investment Decision.

The most important factor in the investment decision is not the product, the size of the market, or even greed. It is people. Management has been found in several surveys to be the most important factor in the decision making process. The five most important factors influencing the venture capitalist's decision making process to invest are (Hill and Power, 2001: 105):

- Quality of the management team
- Size of the company's market
- Proprietary, uniqueness, or brand strength of the company's product
- Return on investment
- The company's potential for growth.

The importance of the different factors has changed since surveys done in 1998 and in 2000. However, the quality of the management team remained the most important factor in both surveys. The change in ranking is depicted in Table 2.5.

Table 2.5. Change in Ranking of Investment Factors.

Year of Survey	2000	2000	1998	1998
Factors	Score out of 5	Rank	Score out of 5	Rank
Management Quality	3.4	1	4.1	1
Growth Potential	2.2	2	3.3	3
Return on Investment	2.0	3	3.5	2
Size of Market	2.0	3	3.3	3
Product	1.2	5	3	5

Source: Hill and Power, 2001: 108 – 109.

The quality of the management team and their cohesiveness and effectiveness are preferred by most venture capitalists. The quality of management is paramount for any investor. Management teams that do not work as a team and with some resulting discord among the members, have an excellent chance to fail at some or other stage of the venture's development. Discord has been found by Camp, (2002: 33) to be the primary cause of venture failure.

Venture capitalists prefer to invest in ventures where the management team has met some success before. Investors are continuously trying to reduce their risk and since, as stated above, the management team determines the success and failure of a venture, it is clear that investors prefer committed and skilled management teams. (Hill and Power, 2001: 224, Camp, 2002: 33 as well as Gladstone and Gladstone, 2004: 64)

Venture capitalists, per definition, are in most cases money managers, whilst the angel investors or private investors invest their own money and are not forced to invest in a

number of different ventures. Venture capitalists concentrate on ventures at later stages of development with a well equipped venture management team (Hill and Power, 2002: 52). It is important that the entrepreneur should understand this fact and ensure that the right team supports him. It is also an indication of the lack of commitment or inability from venture capitalists to transfer skills and knowledge to the entrepreneur and a new management team. The investor cannot only concentrate on the management team and distance himself from the venture or the idea/concept that the entrepreneur has brought to the table. The investor is not only the provider of money, but based on his experience (knowledge) and skills, he should identify excellent ideas and concepts and structure them into ventures that will be successful. In the background and overview of Chapter 2, Figure 2.3, it was indicated under the current phase that the venture capitalists mainly consist of fund managers. It should be borne in mind though that the expertise of most fund managers is in the investment arena, and not in the entrepreneurial and creative arena of the entrepreneur. It could be said that the investment decision is also determined by the skills, knowledge and background of the investor or the investment manager.

The investment decision and the role of the management and investment team is one of the strongest determining factors for an entrepreneur to successfully obtain finance for his venture. The management team is in most cases not complete and new appointments should be made. Many factors influence the appointment of the managers and will be addressed next.

2.5.2 Appointment of the Management Team.

Investors prefer to invest in a venture with a complete management team, but the involvement of the investor to appoint or dismiss parts of the management team will also be determined at this stage of investment. One could expect a much higher involvement if the investor is the lead investor in an early stage investment than where the investor is a non-lead investor in a later stage investment. (Macmillan and Kulow, 1989: 28) The latter does not exclude the investor from playing an important role in the selection of new members for the management team if there should be a need for this role. The

management team would also change as the company develops. Managers who have managed the company from the seed investment phase might find their services terminated when the venture has developed past their level of experience and knowledge. The investors and owners of the venture/company should stay intact with the company and they should identify any dead wood before the company is negatively influenced.

The appointment of the management team is very important for any company and should incorporate the different aspects as explained below.

- **Evaluation.** The venture capitalist or the angel investor has to evaluate the management team before any changes are made. An experienced investor would be able to identify the shortcomings of a management team and the team members during a proper due diligence examination of the management team. (Anonymous A, 2005: 43) as well as (Schefczyk and Torsten, 2001: 1) In the evaluation process, the investor should place a great deal of emphasis on the manager's functional experience and experience in the relevant industry. Managers need to be “streetwise” to add the best value possible to the venture. (Schefczyk and Gerpott, 2001: 1) During the due diligence of the management team, the investor will quite likely concentrate on the following:
- **Quality of the Management Team.** The management team should be constituted of top quality managers. Such managers are scarce and determine the success of the investment. Arthur Rock says in Camp, (2002: 24) that: “Good ideas and good products are a dime a dozen. Good execution and good management – in a word, good people – are rare.” Venture capitalists place a great deal of emphasis on the quality of the management teams because the return they will obtain on their investment depends heavily on the quality of decisions that the management team will make during the time the investor holds an equity stake. Successful venture capitalists become good judges of people. The investor should have the knowledge and skills to evaluate and determine the quality of the

management team. A number of different tools should be used to determine whether the entrepreneur and his management team are reasonable, dependable, responsible and trustworthy people. Once the investor has determined the quality of the management team, the completeness of the management team should be determined. (Camp, 2002: 24 -29) It is certain that the investor should play a very active role and should use his skills and knowledge to determine the management shortfalls long before they become a problem.

- **Completeness of the Management Team.** The venture capitalist has to determine whether the management team is complete and functional in each critical area. These areas are marketing, business development, operations, finance, administration, logistics and any other area applicable to the business. In the early stage investments one may find that all these functions could be executed by one or two people, but ultimately the foundation will not be correct. This does not mean that the venture should necessarily have all the people in the different areas employed from day one, but there should be a plan and alternatives in place. The venture investors have an important role to play in identifying the shortcomings of the team and propose alternatives. The investors may even be forced to use their financial leverage to convince the entrepreneur of the shortfalls or to replace incompetent managers. (Camp and Justin, 2002: 29 - 31)
- **Adult Supervision.** In assessing the management team the investors – based on their experience of previous ventures – should decide whether it is necessary to introduce top quality managers to the company with previous experience in establishing and developing ventures, to complete the management team. This entails replacing founding CEOs with CEOs who have more applicable experience. Venture capitalists find it much easier to invest in a venture if the CEO and management team have a good track record and are known to them. The venture capitalist will always try

to discount his risks of which management is a critical element to success. (Camp, 2002: 31 - 32) The entrepreneur/founder has to be willing to stand back on behalf of the company's success whilst the new CEO has to commit himself to the company. The company, and not the position, should be important to both role players.

- **Diversity and Efficiency.** The management team should be diverse in its skills, background, experience, personalities and perspectives. The team should have the ability to differ from each other, but still co-operate to achieve its aim. Venture capitalists prefer to back management teams that are cohesive and effective in their decision making process as well as in their actions. (Camp, 2002: 32 - 34) The investor will be wary of a management team, manipulated by the founder or any other member of the team. Such a team will become mere followers and would support the dominating founder. The knowledge and skills found in the diversity of the members would then be lost. The biggest challenge in any diverse management team is the ability to work cohesively and effectively to achieve the venture's aim.
- **Past Success of the Management Team.** Venture capitalists would always prefer a management team with a history of success. Teams that have worked together and performed well in the past would have a better chance to be successful again than a new team. This factor should not prevent an investor from investing in a venture with a well-balanced team. If a team is assembled, combining experience with novice managers, which would lead to the transfer of skills and knowledge, they may even be more successful because of new and fresh ideas from the newcomers. The perfect match should be found and the process needs to be managed with care. (Camp, 2002: 34) as well as (Buaan and Silverman, 2004: 417)

- **Commitment of the Management Team.** The management team should be committed to the long-term success of the venture. Although a new manager, and most likely a new CEO, will be appointed to complete the management team, the founders should still realise that they are the co-owners of the business. The venture capitalist should bear the entrepreneur's objectives in mind. The investor and entrepreneur/founder should be committed to realise the potential of the venture. As stated before, the venture needs to be the most important factor and not the personal ambitions of the individuals. (Camp, 2002: 35)
- **Management Team's View of the Investor.** The founders and investors need to have trust in each other, since without trust the venture is doomed to fail. The management team and the investor should share a mutual goal to make money, and in order to achieve this, co-operation is indispensable. (Camp, 2002: 35 - 36) The management team must see the investor as an important factor in achieving the goals they have set out for themselves and not as an outsider trying to hi-jack their company. On the other hand the investor should become an active member of the company and have the interests of the company at heart. He should not be a mere onlooker, but a participant in the venture, actively transferring his skills and knowledge to the management team.

With the due diligence of the management team completed, and after assessing the personalities in the management team, the venture capitalist would now be in a position to appoint additional team members who would complement the current management team. The investor and founder should work together in achieving the appointment of the best management team for the specific venture that will work cohesively and effectively to achieve the expected outcome for the investors and founders.

In the appointment process, preferences will play an important role in the venture capitalist's choice of management team. The venture capitalist with prior knowledge of working in start-ups or large firms would tend to prefer teams with individuals coming from similar backgrounds. Furthermore, venture capitalists with a specific background like engineering would tend to appoint teams with the same background. This approach could be dangerous, and thus the venture capitalist should be objective and appoint the best team for the specific venture. All the relevant factors need to be taken into account before the appointment of the management team is done. (Franke et.al, 2005: 2)

- **Characteristics of the Management Team.**

Certain characteristics in a management team are needed to obtain venture capital. Much research – for example studies by Hill and Power, (2001: 231) and Hill and Power, (2002: 118) as well as Gladstone and Gladstone (2004: 6) – has been done to determine which characteristics are the most important and would be crucial for the success of the venture. Venture capitalists have found that a proven management track record is the most important characteristic. Integrity is second, followed by dedication, commitment, passion, energy and others. Table 2.6 lists the different management characteristics and their importance. Graph 2.1 provides a graphical illustration of the same information.

Table 2.6 Required Management Characteristics and their Importance.

CHARACTERISTICS	IMPORTANCE OUT OF 10
Proven track record	9.5
Integrity	3.0
Dedication, commitment, passion and energy	3.0
Vision and ability to articulate vision	2.3
Knowledge, skill level, intelligence	2.0
Leadership ability	1.0
Ability to build a team	0.75
Marketing focus	0.50
Made Investment in Company	0.50
Winning attitude	0.50
Industry contacts	0.50
Good references	0.25

Source: Hill and Power, 2001: 118.

Figure 2.5 Required Management Characteristics and their Importance.



The characteristics may also be discussed under the following heading compiled from other literature sources. (Bartlett, 1988: 23), (Gladstone and Gladstone, 2004: 6), (Hill and Power, 2001: 118), (Camp, 2002: 36) as well as (Hill and Dee Power, 2002: 231):

- **Quality People.** The venture capitalist invests in the jockey, in other words the people in the venture. The entrepreneur has to ensure that his profile and the people he has employed as his management team would meet these expectations. The descriptions of quality people could be further divided into the following general characteristics of high quality people:
 - **Integrity.** Integrity is the most important quality of great leaders. Venture capitalists have to trust the management of the venture in which they are going to invest their money. Once integrity is lost, the investor is sure to lose his investment. In this context the good guys

are the winners. The owners, investors and management need to be able to keep their focus on the goal without watching their backs and pockets.

- **Intellectual Honesty.** The management/CEO has to have the ability to be honest with the owners and themselves. They should be able to identify problems and realise when they are in trouble. Ignoring problems and not addressing them, would invariably lead to financial losses. People tend to ignore the major issues because they know that it would be detrimental to the venture and their position. If a problem is identified in good time it could be addressed and resolved.
- **Intellectual Brilliance.** Managers need to be smart people, smarter than the average man in the street. They should have the ability to think on their feet and give well-calculated answers that are correct and defensible. The managers and CEO need to have the ability to create clarity from confusion, ambiguity and uncertainty, all of which are constantly present in early stage companies.
- **People Smart.** Venture capitalists prefer entrepreneurs and managers with great interpersonal skills and abilities, in other words they need to be people smart. Entrepreneurs, who have the ability to deal with the staff and management, would also encourage everybody to work together in achieving their goal.
- **Real Entrepreneurs.** The members of the management team, or at least some of them, have to be real entrepreneurs who have the ability to identify the opportunities and to exploit them. The entrepreneur should have sustainable motivation and be willing to put in some hard work. An idea is not a venture. The following characteristics are important entrepreneurial characteristics needed and sought after by venture capitalists:

- **Driven Intensity.** The entrepreneur has to be self-motivated with the ability and willingness to work hard in ensuring success.
- **Bold Self-Confidence and Willingness to Take Risks.** It is imperative for venture capitalists to back entrepreneurs who have the guts to undertake risk and fully commit themselves to achieving the goals set.
- **Sense of Vision and Ability to Execute.** The entrepreneur needs to have the ability to see into the future and then concentrate on the important objectives to remain a step ahead of the market.
- **Ability to Solve Problems.** The nature of an early stage company is such that the entrepreneur should have the ability to solve problems, big and small. Venture capitalists tend to back entrepreneurs who have the ability to resolve these problems effectively. The entrepreneur needs to have the ability to identify key problems and to select and implement optimum solutions.
- **Ability to Adapt.** The manager/entrepreneur finds himself in a market that is constantly changing. The manager should have the ability to adapt to this changing environment and situations. The inability to adapt will almost surely doom early stage companies to failure.
- **Ability to Use Resources Effectively.** Managers should have the ability to preserve scarce resources like finance, personal and other resources. The managers should be able to employ the best personnel for the company and manage the available finances to the fullest. The ability to use and apply resource effectively will give the company the ability to be profitable much earlier in its existence.

- **Business Judgement.** Logic prevails and the managers need to be able to make rational decisions based on logical thought and not based on emotions or prejudice. Business judgement is learnt through experience, and seasoned managers who are “streetwise” tend to be better equipped for entrepreneurial success than people with relatively little experience.
- **Background.** Members from the management team should have an impressive and relevant background in terms of both experience and education. The experience should preferably be in the same industry than the one the venture is pursuing. Someone who has worked in the industry would understand the requirements and needs of the industry much more quickly and easily. He will also know all the suppliers and competitors in the market, with their strong and weak points, and would be able to better position the company. Knowledge of the market, suppliers and competitors would give the company a competitive edge over any other newcomers in the same industry.
- **Motivation.** The management team has to have the motivation and sustainability to be part of the company. A management team should work towards a single goal with a great deal of energy and believe in what they are doing. Motivation is everything in building a company. The venture capitalist has to assess each management team member’s motivation. With all the knowledge and skills gathered over the years the venture capitalist needs to motivate and keep the team motivated. The role of the venture capitalist is critical in this regard. Discerning motivation and determining whether those motivations are proper and healthy, is a tricky business. Motivation only founded on financial grounds may be detrimental to the company’s development. The venture capitalist has to ensure that management’s expectations and motivations are matched if set realistically.
- **The Peter Principle.** It is when the manager reaches the end of his ability, long before the company has reached its full potential. The venture capitalist

should be aware of these possibilities and take the right action before the manager becomes dead wood and a liability to the company. It should be realised that everybody has his specific abilities and the venture capitalist, with his vast experience, has to identify managers with a limited ability or experience and try to assist this manager in building more capacity. It costs more to bring a new manager into the business than trying to correct the problem early enough.

The selection of the right management team and managing this team is an important function of the venture capitalist. The venture capitalists need to use all his skills and knowledge to manage the management team and managers to ensure that the company would benefit from their knowledge and skills. The venture capitalist will help the management team not to reinvent the wheel. The correct selection of this team would enhance the company's chances on success and future prosperity.

2.5.3 Dismissal of the Management Team.

The appointment of a management team may culminate in the dismissal of members or the whole management team. Venture capitalists may use their financial power to dismiss members or the whole team if they are of the opinion that the team is under-performing or does not live up to expectations. Replacing management is one of the most significant undertakings that the venture capitalist can execute. The venture capitalist has to evaluate the situation objectively and if necessary dismiss the team or team members. Dismissing a team or team member is also not proven to increase performance, and it may have a rather negative effect on the venture's performance. The venture capitalist may have a major task restoring the confidence and team spirit in order to increase the company's performance. (Gorman and Sahlman, 1989: 241) and (Busenitz, Fiet and Moesel, 2003: 792 - 793)

Dismissing a management member can strain the venture's growth and prosperity. It is in the company's and venture capitalist's interest that dismissals are restricted to the

minimum. The management team should be finalised before investment takes place. Finalisation of the management team should be an initial requirement for investment to be made. (Fiet and Busenitz, 1997: 347) Changing the management team after investment could lead to negativity in the company. Entrepreneurs should also be wary of venture capitalists that are known to take over company management teams after investment has taken place. The interests of the company, shareholders and investors should be taken into account in the evaluating process determining the need to change the management team. “Vulture capitalists” with their egocentric and short-term approach, may well ruin the long-term existence of a company. In a study by Macmillan and Kulow, (1989: 39) the contrarily was found that they could not find a direct correlation between the replacement of a management team and the positive performance of a company. Cognisance should be taken of this research although enough research indicates the opposite.

The four most common reasons for dismissal of a management team is the inability of managers to (Fiet and Busenitz, 1997: 348):

- Make strategic decisions
- Work with the board of directors
- Motivate the employees
- Adequately allocate resources.

The performance of the management team should be evaluated in an objective manner, and the venture capitalists should attempt to withhold emotions and perceptions from the evaluation process. The mere fact that an investor and a management member cannot see eye to eye is not enough motivation to replace such a manager. The contribution made to the company should be the determining factor. The venture capitalist must be objective with the company’s interests at heart. When the venture capitalist demonstrates his willingness to treat the management fairly, more of the enthusiasm of management, after a dismissal, will be resumed. (Macmillan and Kulow, 1989: 348)

Dismissal may be viewed in four different ways (Fiet and Busenitz, 1997: 349):

- **Agency Theory.** This represents an attempt to constructively influence a possible conflict of interest between the managers and the investors. The original structure of the deal conveys important information about joint expectations for the future and what may happen under specific scenarios. If the expectations are not met, the managers would be dismissed. The targets could be sales targets, profit targets and production targets. The managers are appointed as the agents of the investors to achieve certain targets. This theory is very much concentrated on the short- to medium-term. The investors are not expected to participate actively in the company's management.
- **Power Theory.** The investor can control the board of directors as a prerequisite to investment, which is used later as a tool to dismiss underperforming managers. One way to maintain power is to control access to information, which is obviously a very negative action. Such actions revolve around control, and are mostly at variance with the initial goal that the founders and investors aimed to reach together.
- **Board Diversity.** The most frequent type of diversity is the distinction between inside and outside venture directors. Venture insiders are directors also on the management team, whilst the outsider is a venture director not on the management team. When a board is filled with outsiders they may well be more willing to dismiss managers than otherwise.
- **Procedural Justice Theory.** Procedural justice theory suggests that because the managers expect to be treated fairly by the investors, the power of the investors is constrained. The investors are able to exercise power, but only in a fair way. The investors and the managers agree to work together to achieve their goals. The investors ensure that the managers stay focussed. If a dismissal needs to take place the dismissal will be accepted by both parties.

Dismissal is a very sensitive action that is always necessary wherever a business exists. Against this background the venture capitalist's actions should be fair. Managers are appointed to achieve certain goals and they have to be committed and dedicated to achieve these goals. Dismissals should not be used as a tool to gain personal power, but as a necessity to achieve certain goals. Well-communicated dismissals could be positive if they are justifiable and in the company's interest. The investor has an important role to rather fix what is wrong before any dismissal takes place. The investor has to weigh up the consequences of dismissal against the possibility of resolving the problem without dismissal. The pressures of a new venture are fierce enough and should not be cluttered by power struggles.

2.6 Conclusion.

This chapter concentrated on the ownership, company control and management aspects of a new venture. It was indicated what the role and influence of the venture capitalist/investor are. There was some reference to the difference between the venture capitalist and the angel investor (private investor), but this aspect will be discussed in more detail in the next chapter. The venture capitalist has a very important role to ensure that the management structure is balanced and correct. The new venture needs to be in a position to succeed. The entrepreneur must realise his shortcomings and has to be open enough to allow external inputs into the venture. The quality of the management team of any venture is the most important aspect determining its success or failure. However, it would be unrealistic to expect all ventures to have a perfect and balanced management team in the early stages of investment. The cost of having a full management team in an early stage company may be detrimental to the venture's existence.

The entrepreneur/founder should also realise that he would need all the management qualities, and during the earlier stages of development he should appoint external directors/ advisors to advise him and his team. Reinventing the wheel is not an option, and one should use existing knowledge and concentrate on the market before losing the competitive advantage. Venture capitalists tend to invest in ventures where the

management team has been established and where they would be able to take control of the board of directors because of their financial power. Many risks go hand in hand with the above approach. The investors may through his actions eliminate the entrepreneur's drive, which may be detrimental to the company. It is in the investor and investee's interest to ensure that all actions are taken to the benefit of all. The knowledge and skills of the investor is critical in any new venture and simply has to be utilised. The entrepreneur needs to be open enough to learn from the investor and the investor should make his knowledge and skills available to the entrepreneur and his team. This implies that the investor with the knowledge and skills in his armour has to play a very important role in the success of the company. Commitment is equally expected from the investor as from the entrepreneur and the management team.

In the next chapter the role of the venture capitalist and angel investor, as well as the entrepreneur, will be addressed. In assembling a management team and board of directors, the personalities and differences in skills of specifically the entrepreneur and the investor should be considered. The risk factor of venture investment requires that one has to look further than merely pure investment principles. The risk of venture capital investment should be understood and reduced to levels commensurate with return expectation.

CHAPTER 3 OVERVIEW OF THE CHARACTERISTICS OF THE ROLE PLAYERS INVOLVED IN VENTURE CAPITAL

3.1 Introduction.

The previous chapter concentrated on the structure of the company's ownership, non-executive directors, board of directors and the management team. In understanding the complexity of venture capital and angel investing better, one should also consider the differences between venture capitalists, angel investors and entrepreneurs, including their role in the investment process. Knowledge management is a critical element in the success of any venture. It needs to be managed properly and utilised to the fullest extent. With a view to addressing the reasons for success and failure, the personality differences and thinking preferences of the entrepreneur and the investor are important aspects to be borne in mind. The development in the venture capital investment market should be assessed and noted. An eagle's view has to be taken of the investment process and the persons involved, understanding the importance of the transfer of knowledge and skills between the investor, the entrepreneur and his management team.

3.2 The Relationship between the Entrepreneur, Venture Capitalist and Angel Investors.

Entrepreneurs, angel investors and venture capitalists have specific roles to play and inputs should be given in the investment process and the success of the venture. The entrepreneur may well have a preference for a certain kind and type of investment and the role he expects the angel and venture capitalist to play. This role, however, should not be determined by the entrepreneur on his own, since he is not always a seasoned business person who would necessarily have been involved in building a successful venture in the past. The roles of the different role players, as explained in Figure 2.1 to 2.3 have changed over time. The initial role of the venture capitalist has been taken over by the angel investor, whilst the venture capitalist fulfils the role of fund manager today. Angel investors mostly invest their own money, whilst a venture capitalist invests investors'

money. A further difference between the two kinds of investment is that the angel investor normally invests smaller amounts and is mainly involved in the earlier stages of the venture development. Venture capitalists, on the other hand, are more involved in later stage investments that demand larger investments. The role of the venture capitalist is fund managing and he no longer has the entrepreneurial skills or previous experience to transfer knowledge and skills to the venture's management team. The role of the entrepreneur has remained more or less constant as in the past.

The angel investors and venture capitalists are briefly defined in the following two sections.

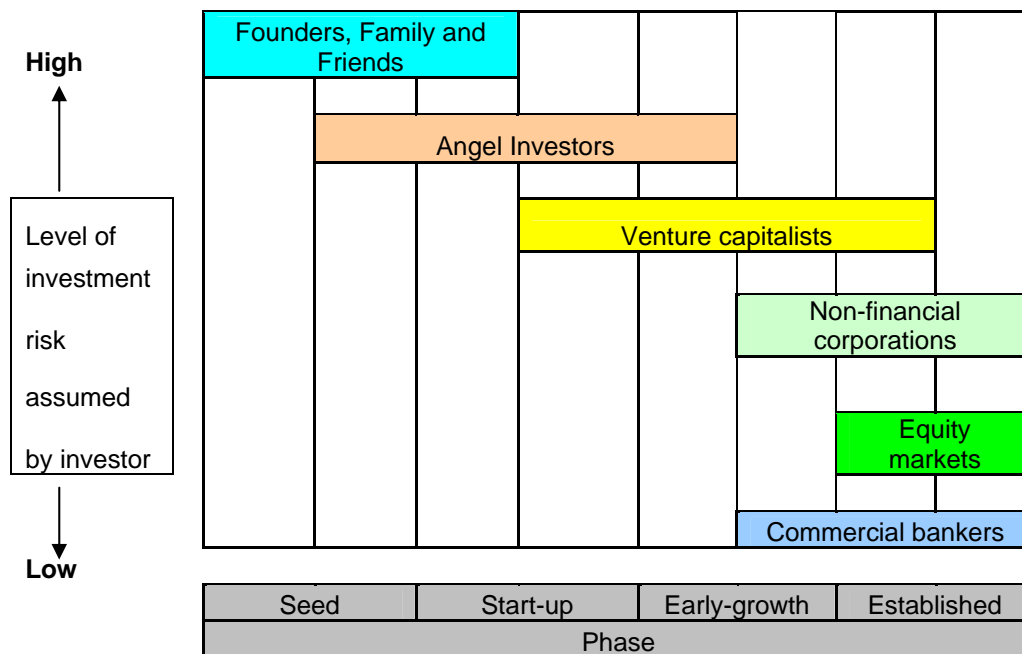
3.2.1 Angel Investors.

The following aspects are addressed:

- **Definition.** Angel investors are persons, partnerships, or corporations that use their own funds to invest in private companies, which are often early stage concerns, but not exclusively so. Their way of operating is in contrast to venture capital firms that raise money from institutions like pension funds and insurance companies as well as from wealthy individuals, and then invest that money on behalf of these limited partners primarily in later stage companies. Venture capitalists, therefore, tend to be more money managers than the hands-on angel investors, as defined above. (Hill and Power, 2002: 5) It is often found that the angel investors are people who have just completed the successful building of a venture and who have sold it. They would typically be searching for a new opportunity to invest their money, knowledge and skills.
- **Risk.** The funding of early stage companies or ventures involves a high degree of perceived risk. Venture capital firms and the broad financial market often refer to early stage companies as risk-capital. The risk of these investments is increased by the venture capitalist being a fund manager who

may not be streetwise enough in the building phase of successful ventures in order to contribute to the success of these ventures. The Afrikaans translation of venture capital investment is “waagkapitaal” (risk capital), which partially explains the reluctance on the part of the South African investment community to invest in these kinds of investments. (Clarke, 2006: s1) In labelling an investment process as a risk, without assessing the true value and risk of the investment channel, will be short-sighted. The investor has an important role to transfer his skills and knowledge to the entrepreneur and his management team and through this whole process to reduce the risk regarding the investment. The experience, knowledge and skills of the angel investor enable him to be the ideal partner to reduce the risks in the early stage investment. The risk factor would only be reduced if the investor transfers his knowledge and skills to the venture. Angel investors sometimes invest in a deal that may not even relate to a company as yet, but which has the potential. The potential is identified through their investigations and in the process of due diligence the angel investor has the opportunity to identify the vision of the entrepreneur and buy into it. These kinds of actions may increase the risk potential, but the business of venture capitalists and angel investors is the business of creating businesses. The angel investor is by nature an entrepreneur who has made a profit from previous ventures and because of his nature, he would be able to appreciate the potential of the venture (Hill and Power, 2002: 11). The potential return on investment in early stage investments is much higher but, in comparison to later stage investments, the commensurate risks are much higher. Knowledge and skills are often lacking and the need to be mentored is consequently so much higher. In assessing the risk in a potential investment, all the different types of risks involved need to be studied and evaluated. (Hill and Power, 2002: 8 – 9), (Benjamin and Margulis, 2001: 55 – 67), (Van Osnabrugge and Robinson, 2000: 36 – 60) as well as (Rea R.H, 1989: 154) The stage of investment and the concomitant risk involved may be represented as indicated by Figure 3.1, below.

Figure 3.1. Model of the Main Providers of External Finance through the Evolution of the Entrepreneurial Firm.



Source: Van Osnabrugge and Robinson, 2000: 37.

Assessing the risk is part of the due diligence process of the angel investor and the venture capitalist before investing, but it is important to analyse the different kinds of risk with which the investor will need to deal which are as follows (Benjamin and Margulis, 2001: 59):

- Management Risk.** The investor needs to ensure that the management team would be able to execute the business plan they presented to the investor. All the aspects concerning management – as described in the previous chapter – are of importance here. Management risk is seen to be the most important risk to be assessed by the investor. As stated in Hill and Power, (2001: 50) a good management team with a less than perfect idea is better than a good idea and a bad management team. According to Bartlett, (1999: 72) the investor will back the right

jockey. The entrepreneur should also take note of the importance of a capable and well-equipped management team before presenting his venture to investors.

- **Product and Technology Risk.** The investor has to ensure that know-how plus the prototype equals a workable piece of technology that could be produced cost effectively. Protection of the product and technology through trademarks, copyright and exclusivity should be high on the priority list. The less protected the above is, the higher the risk of losing the relevant technology to competitors.
- **Marketing Risk.** The investor should determine through the process of due diligence whether there is a demand for the product, or whether the product would depend on missionary sales. Previous experience and knowledge of the specific market segment and customers are important factors in making an informed decision.
- **Operations.** What is the company's ability to meet its sales projections and is the company actually able to produce enough high quality products to meet customer expectations? It is not sufficient merely to have a good product that may be well-protected, dispose of a good management team and marketing plan, if one cannot adhere to the demand, or at least have a clear plan in hand on how to adhere to the increasing demand.
- **Money Needed.** A major risk for any investor is that the amount of investment really needed may prove to be much more than initially anticipated. Many entrepreneurs do not have the ability to anticipate what their real needs are and they are frequently forced to solicit a certain investment merely to get them over the next, or current, hurdle. The lack of experience, knowledge and skills on the part of the

entrepreneur in assessing the real needs, as well as the long-term implications, is critical in any investment process. The investor has to be sure what the true financial needs of the venture are, before he should consider investing in such a venture.

- **Angel Investors versus Venture Capitalists.** A comparison of the role of the venture capitalist and the angel investor indicates the importance and role of each one. These different kinds of investors complement each other, but simultaneously their roles also overlap, as may be seen in Figure 3.1 above. A chain is formed and the one without the other would distort the investment process. In summary the comparison between angel investors and venture capitalists is as follows (Hill and Power, 2002: 49 – 60), (Sorhiem. 2005: 179), (Benjamin and Margulis, 2001: 252 – 253) as well as (Van Osnabrugge and Robinson, 2000: 63 - 67) :

- Venture capitalists advertise their location, whilst angels tend to hide it. Angel investors prefer referrals and do not want the entrepreneur merely to send his business plan to them. They would typically make their own assessment of the market, the entrepreneur, and the venture's potential. Venture capitalists need to have an appetite for the kind of market in which the venture is, before they are presented with a business plan.
- Venture capitalists have a definite focus on technology investments, whilst angel investors are attracted to technology investment but will consider many other types of investments too.
- Venture capitalist have more financial, due diligence, valuation skills and are more formalised in each of these areas. The angel investor may decide to invest long before the due diligence process is completed on the basis of a “gut feeling” that a product or venture will be successful (Dubini P, 1989: 131). The risk of investing on this basis would subsequently

increase. The investor should be careful to invest in a venture where the entrepreneur has good marketing skills, but the venture is sub-standard.

- Successful angel investors, who remain in investing for long periods of time, may even have more success in picking winning investments than many venture capitalists. Angel investors tend to have a more hands-on approach, by means of which they would be able to add more value to the venture, but would typically also have the experience to identify risks and problems long before the venture capitalist, who is ultimately a fund manager.
- Angel investors invest much smaller amounts in an average deal than venture capitalists do. Angel investors invest their own money and do not join other investors, paying money into a venture or investment fund. Venture capitalists prefer to invest in later stage companies and also invest much larger amounts.
- An angel investor's flexibility in terms of the size of the investments made increases the possibility that angel investors invest in early stage investments. The return on investment is also higher than in the later stage investments, as indicated by Table 3.1 below.

Table 3.1. United States of America Private Equity Performance Index - Return on Investment. (PEPI) as on 31/12/2000.

	Year 1	Year 3	Year 5	Year 10	Year 20
Early stage/ Seed	51.20%	93.70%	65.50%	35.80%	23.80%
Later stage	19.90%	31.70%	31.10%	25.20%	18.30%

Source: Hill and Power, 2002: 10.

- Venture capitalists like to think of themselves as professionals, having worked with presumably amateur angel investors.

- Angels and venture capitalists do not necessarily view each other positively, but each of them offers entrepreneurs with investments needed.

3.2.2 Venture Capitalist.

The following aspects are important:

- **Definition.** A venture capitalist was defined in chapter one as a person involved in Bartlett, (1988: 2):
 - New technology development, new marketing concepts, and new product application possibilities.
 - Significant, although not necessarily controlling, participation in the company's management.
 - Investment in ventures staffed by people with outstanding competence and integrity.
 - Product processes that have passed at least through the early prototype stage and are adequately protected by patents, copyrights and trade secret agreements.
 - Situations which show promise to mature within a few years to the point of an initial public offering (IPO) or a sale of the entire company.
 - Opportunities in which a contribution beyond the capital amount of money invested could be made.

The definition has changed over the years, but in principle remained remarkably stable. A definition by Benjamin and Margulis, (2001: 7) defines venture capital as “the business of building businesses”. As a business changes over the course of time, the basics do not change, but the role players do so. Such changes amongst the role players may also influence the areas in which the venture capitalist would like to become involved.

- **Areas of Involvement.**

The entrepreneur and the venture capitalist have different needs and rate the importance of involvement and types of involvement differently. A study conducted by Macmillan and Kulow, (1989: 27 to 41) and followed up with further research by De Noble, Ehrlich and Moore, (1994: 67 to 81) highlighted the activities with the most and the least venture capital involvement. Please see Table 3.2 below.

Table 3.2. Ranking and Comparison of Venture Capitalist and Angel Investor Involvement in Investment Activities.

	Venture capital funded entrepreneurs	Angel investment funded entrepreneurs
Activities of greatest involvement		
Interface with investor group	1	1
Obtain alternative equity finance	2	6
Monitor financial performance	3	2
Sounding board	4	3
Monitor operating performance	5	5
Formulate business strategy	6	4
Activities of least involvement		
Develop production or service techniques	20	19
Select vendors and equipment	19	19
Develop actual product or service	18	17
Testing or evaluating marketing plans	17	17
Replace management personnel	16	15
Develop professional support groups	15	17

Source: De Noble and Ehrlich and Moore, 1994: 75.

The expectations of entrepreneurs and of angel investors related to their respective kinds of involvement differ substantially, although there are some similarities too. The six highest ranked involvement areas for angel investors

and venture capitalists are similar, although not ranked in the same order. The entrepreneur, in short, expects investors to (De Noble, Ehrlich and Moore, 1994: 80):

- Give advice on locating and attracting key management personnel to their firm.
- Provide financial and staffing expertise. The entrepreneur per se expects the investor to transfer his/her knowledge and skills to the venture.

It is clear from the above that the venture capitalist, the angel investor and the entrepreneur differ quite substantially in what they deem to be important and the roles that each play. Someone in the management team, normally the CEO, needs to have the ability to be a mediator in order to accommodate all the differences of opinion between the parties involved and to be able to let them work cohesively together. Differences may occur, but the company remains the most important and central element, together with the success of the investment. The parties involved need to overcome their differences and effectively work together in achieving their goals. If not, conflict will erupt, and the company would most probably be the loser. (Maier and David, 1987: 209)

○ **Conflict between the Entrepreneur and the Venture Capitalist.**

Conflict has broadly been defined as perceived incompatibilities, discrepant views, or interpersonal incompatibilities between two parties that may have more than one dimension. Conflict could be positive or negative, depending on how it is managed. Examples include cognitive conflict and effective conflict, where cognitive conflict relates to functional task orientated discord. Effective conflict refers to dysfunctional and emotional disagreements, such as disputes between the venture capitalist and the entrepreneur. It is important to experience cognitive conflict in the development of the venture and its

products. Too little cognitive conflict could lead to inactivity because of a lacking sense of urgency. Should everyone agree, the venture will lose the ability to tailor-make a product or marketing proposals. Each person on the management team should give his/her inputs freely regarding the matter under discussion. It may just be the specific question or reply that would make the product an achiever. The entrepreneur should always be challenged so that he/she may continually perform to the best of his/her ability. Conflict needs to be managed positively to realise every person's potential without destroying the company. (Higashide and Birley, 2002: 62) Positive conflict is the unformulated way of transferring skills and knowledge. Tabling differences of opinion, followed by a discussion and acceptance of a specific adjusted route, will ensure that the management team would use the knowledge and skills available thus preventing them from repeating previous errors.

Many reasons for conflict could be adduced, but the main reasons are (Hill and Power, 2001: 14) and (Higashide and Birley, 2002: 60):

- Typically entrepreneurs do not want partners; they want money.
- Frequently the ego of the entrepreneur and/or the investor is overly developed.
- The so-called class distinction between investor and entrepreneur may also play a role in certain countries.
- Greed.
- Entrepreneurs may feel intimidated by venture capitalists.
- The goals of the entrepreneur and venture capitalist start to diverge.
- Policies adopted by the investee company are unacceptable to the investor.

The relationship between the entrepreneur and the venture capitalist should be one of trust and respect, and the entrepreneur should realise that the business concern is still his company, although shared. Conflict is essential in any company as long as it is healthy and executed with respect. Investors and

entrepreneurs should always understand that building a successful company requires a complex set of skills, experiences and personal traits. Foremost among these are the drive to succeed, integrity and vision. (Camp, 2002: 35) and (Hill and Power, 2002: 82)

The complexity of the relationships between the entrepreneur, angel investor and the venture capitalist, as discussed in paragraph 3.1 above, forces the parties involved to ensure that they are able to work cohesively to achieve their goals. This is the ideal and many ventures may well fail because of the reasons mentioned above, of which greed and incompatibility is the most important traits of all. The investor has an important role to play in the transferring of skills and knowledge. The venture capitalist is not excluded from these tasks, although the entrepreneur should be prepared to accept the inputs made. The business related expertise of the venture capitalist is replaced by investment knowledge that may not necessarily contribute to an entrepreneur's need of management and entrepreneurial knowledge and skills. Knowledge management is one of the most important resources needed by a company to gain a competitive advantage. These resources need to be managed and integrated to help the company and its management team to achieve their set goals and objectives (Widding, 2005: 595). Utilising the knowledge in the investment group, combined with the knowledge of the management team, should give a venture an advantage over competitors.

3.3 Knowledge Management.

Knowledge is not only what we learn from text books or in a classroom, but it is much more than that. Knowledge is defined by Dana, Korot and Tovstiga, (2005: 15) as "the integration of information, ideas, experience, intuition, skill and lessons learned that creates added value for a firm. Innovation is the process by which knowledge is transformed into new or significantly modified product and/ or services that establish the firm's competitive edge." In order to gather knowledge a person should be prepared to

sweat it out, get a person's hands dirty and experience the skills and knowledge that a person needs to build up a knowledge reservoir to become the core from where value can be added to other ventures. Entrepreneurs and new team managers need to be prepared to learn from investors who have more knowledge than they have. Investors ought to be prepared to transfer their knowledge and skills to the entrepreneurs and new team members. The value of adding knowledge to a person's knowledge-tank could perhaps be best explained by filling a tank with water. If water is continued to be added, the tank will fill up more. However, if the water is let out, other tanks, linked to the one letting the water out, will be filled. Equally, once a person has some water (knowledge) in his/her tank, that person can start to share (transfer) it to others. The more a person shares, the sooner the new tank, (entrepreneur – new team member) will fill up. Interestingly the tank of knowledge will not be depleted the more it is shared, but it will actually fill up more as more knowledge is added to the tank. It stands to reason that to understand knowledge and the ability to share it, a person also needs to understand what it entails.

3.3.1 Tacit and Explicit Knowledge.

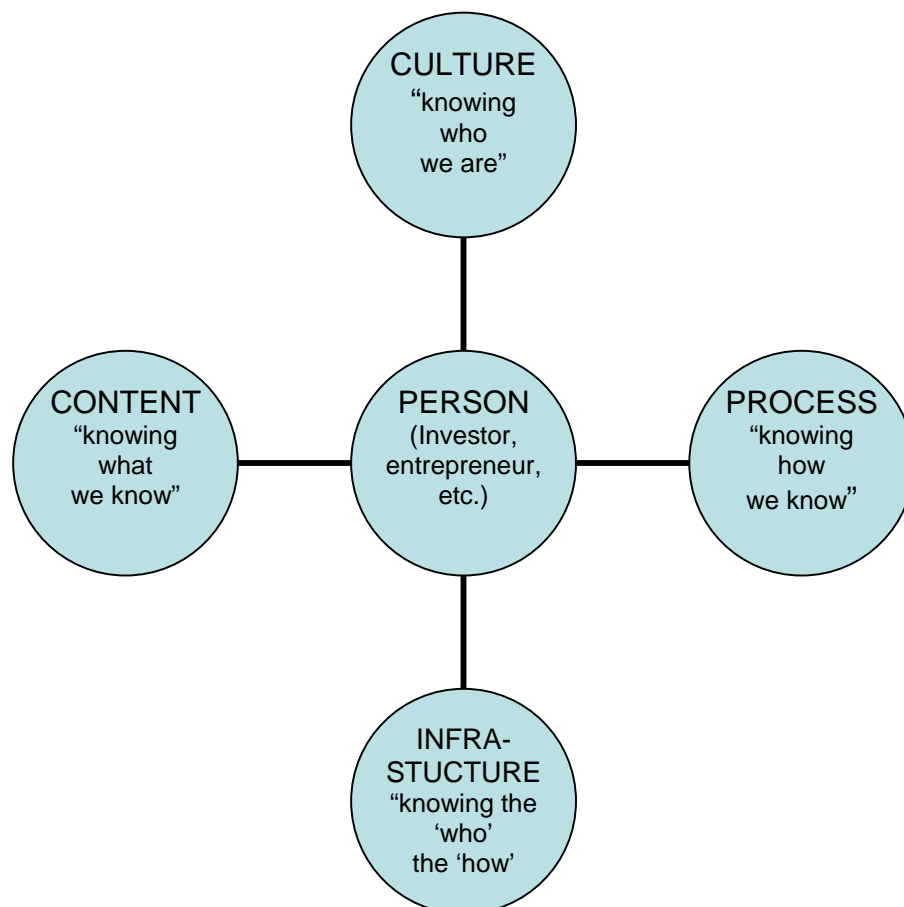
Explicit knowledge is gained from books, studies, manuals and reports. This is to fill the knowledge reservoir up by reading or studying without getting a person's hands dirty. Although a person might be able to build a very good foundation, the ability to apply this knowledge gained in practice, will be lacking. Many students, entrepreneurs and investors are ignoring the fact that tacit knowledge is needed to apply the gained explicit knowledge effectively. In contrast tacit knowledge consists predominantly of intuition, feelings, perceptions and beliefs. In other words, previous experience, including explicit knowledge, enables evaluation and addressing of specific scenario or situation. This may be defined as a "gut feeling". The latter is not learnt, but it is gained through experience, hard work and applying the explicit knowledge learnt. Tacit knowledge could be seen as the essence of innovation. (Dana, Korot and Tovstiga, 2005: 10) Understanding the different knowledge categories will enable the entrepreneur to understand where he is lacking and will assist the investor to realise how important his/her knowledge is because of previous experience. It is quite possible that investors may lack this experience,

especially in the banking sector and venture capital market, because they are mainly expert fund managers. This lack of experience on the part of investors could be overcome by means of the use of external and non-executive directors who have the desired experience.

3.3.2 Managing Knowledge and Innovation.

Managing knowledge and innovation is a multidimensional challenge. It requires the understanding of the four interlinked domains of culture, content, process and infrastructure; all of which have a tacit and explicit dimension. (Dana, Korot and Tovstiga, 2005: 11 - 12) Figure 3.2 depicts the principle. The different components may be explained as follows:

Figure 3.2. Organisational Knowledge Domains.



- **Knowledge Culture.** (Knowing who we are). It is the domain where values, beliefs and behavioural norms are played out. These are the deeply imprinted beliefs that guide an individual's behaviour.
- **Knowledge Content.** (Knowing what we know) Strategically relevant knowledge, both explicit and tacit, exists in the form of:
 - **Experiential Knowledge.** Highly tacit knowledge derived from previous experience.
 - **Formal Knowledge.** Refined, documented and highly explicit in nature.
 - **Emerging Knowledge.** Both explicit and tacit. It is the knowledge emerging from cross-disciplinary interactions in a venture. It occurs in the transfer of knowledge and skills by the different parties, mainly from the investor to the entrepreneur and the new management team.
- **Knowledge Infrastructure.** (Knowing the how and the where). This domain encompasses all functional elements in a venture that support and facilitate the management of knowledge. Knowledge needs to be available so that everybody in a venture or company may access it.
- **Knowledge Process.** (Knowing how we know) This relates to knowledge of how knowledge is created, converted, transferred, applied and ultimately discarded.

3.3.3 Entrepreneurial Knowledge Reservoirs.

Knowledge, as stated above, is the most important resource in terms of a company gaining a competitive advantage over another company. Both start-up and early stage companies would most likely not dispose of the required resources in-house. These resources are found through strategic alliances, joint ventures, forums and clusters in order to access knowledge and capabilities unavailable internally. An entrepreneurship expert has formed and now manages the Toronto Entrepreneur Mastermind Groups, consisting of sets of small business owners who meet on a regular basis to collaborate, brainstorm and provide support for each other's goals. The concept of mastermind groups has recently started to become more popular, but it is in fact not something new. Napoleon Hill first described the notion in his 1937 book, "Think and Grow Rich" (Carmichael, 2006: 1). A company's development is determined by the availability of eight cornerstones. These cornerstones are (Widding, 2005: 598):

- the business idea,
- the product,
- the market,
- the organisation,
- core group experience,
- core group drive/motivation,
- customer relations, and
- other relationships.

These cornerstones constitute the business platform. The risk of failure will increase drastically should any of these cornerstones be absent.

The entrepreneur and the investor should realise that it is critical to utilise and access the existing pool of knowledge. It is a fact that nobody has complete knowledge needed to ensure that a venture will be successful. Family and friends are the early contributors to a venture, but in most cases they are not important contributors when it comes to business knowledge. Widding, (2005: 602) stated that even angel investors are sometimes found lacking, because not all of the angels have the resources or experience to transfer skills

and knowledge to the venture. In some cases they only have the funds, but not the skills and knowledge required. Venture capitalists also fall in this category, especially if they are fund managers with little to no experience as entrepreneurs. For his part the entrepreneur, together with the whole venture team, needs to realise what is needed and should ensure that the skills and knowledge pool is acquired, internally or externally, so as to equip the venture with the best opportunity to succeed.

3.4 Personality Analysis of the Investor and the Entrepreneur.

In selecting board members, non-executive directors, CEOs and a management team, one of the main concerns is whether or not the team would be able to work together. The more cohesive the team is, the better the end result is likely to be. The entrepreneur and the investor are two persons who have to be able to work together. The entrepreneur needs to understand the fears and expectations of the investor, whilst the latter on the other hand, should understand the fears and expectations of the entrepreneur. Some studies revealed that an investor normally does add value, whilst other studies indicated the contrary, namely that the investor adds no, or only a little, value to the venture and the entrepreneur. (De Noble, Ehrlich and Moore, 1994: 71 and 80), (Murray and Wright, 1996: 24) as well as (Higashide and Birley, 2002: 61) The intriguing question remains: why do some entrepreneurs rate the contribution of the investor highly and why is this contribution not rated equally highly by other entrepreneurs? The answer to this question may partly be found in the split brain theory of Roger Sperry.

3.4.1 The Split Brain Theory.

The split brain theory was developed by a neurosurgeon, Roger Sperry, who won the Nobel Prize by proving his theory of the controlling influence exerted by the split hemispheres of the human brain. This theory presents the two hemispheres as equal partners performing varied tasks to achieve a whole product. The left brain controls the linear, logical, and verbal abilities, while the right brain controls the visual, creative, and intuitive abilities, as shown in Table 3.3.

Table 3.3 Control of Abilities.

Abilities controlled by the left brain.	Abilities controlled by the right brain.
Seeks component parts, looking to discern features of the whole.	Seeks the integration of component parts into a whole
Analytical	Pattern seeking
Sequential	Relational
Temporal	Spatial
Verbal	Visual

Source: Randle, 2000: 260 – 261.

The matter of brain preferences is important because it predisposes one to certain likes and dislikes, skills and failings. The ability to work as a team and to build a successful venture is dependent on the ability of the team to appreciate the differences between humans as well as the knowledge and skills available to be utilised. Dr Kobus Neethling developed this notion further into the Neethling Brain Instrument (NBI™) (Neethling 2005: 3 – 5). This instrument will be discussed below in order to provide an insight into the instrument and the differences between the entrepreneur and the investor. Other instruments determining personality dominance or leadership abilities do exist. These instruments may also be used with positive effect.

3.4.2 Neethling Brain Instrument (NBI™)

- **Development.**

The Neethling Brain Instrument was developed over many years by Neethling, who conducted research in the USA under Professor Paul Torrance (Neethling, 2005: 3). The aim was to research the split brain theory of Roger Sperry. The theory was further developed and it was subsequently realised that humans actually have four brain quadrants. Each of the quadrates, as described by Neethling, performs a certain set of tasks or procedures pertaining to the

environment in which one prefers to work; how structured and unstructured a person would wish a job to be; preference in terms of working with specific types of information; how people-focused a person is, including many other differences. In Table 3.4 the different attributes of the quadrants are represented (Neethling, 2000: 1 - 4).

Table 3.4 Thinking Preferences within the Brain Quadrants.

Left (L) front (1) = (L1)	Left (L) rear (2) = (L2)	Right (R) front (1) = (R1)	Right (R) rear (2) = (R2)
Accuracy Digging deeper into a problem. Precision. Exactness Focused approach. Factual reasoning. No nonsense approach. Objectivity. Information with no hidden meanings. Critical. Correctness. Goal orientated Real things Facts and rational information are of fundamental importance. Factual memory tends to get priority.	Planning. Practical application. Organisation. Promptness. Discipline. Dedication. Step-by-step approach. Details. Operational. Tidiness. Tradition. Procedures. Routine. Rules and regulations. Structure. Orthodox. Prefers to follow guidelines.	Search for alternatives. Prefers the big picture. Idea intuition. Strategy. Synthesis. Integration. Risk. Restless. Becomes bored quickly. Experimenting. Diversity. Comfortable with chaos. Fantasy. Surprise. Association.	Feeling orientated. Empathy. Social liaison. People environment. Interaction. People-intuition. Co-operation seeking. Atmosphere of caring. Body language. Touch. Passion. Communication. Listening focus. Ambiance.

Source: Neethling, 2000: 1 – 4 and Neethling, 2005: 4.

Neethling found that when a person is engaged in an activity for which he/she has a natural preference over the long-term, then it is quite likely that a remarkable amount of motivation, passion and drive will remain in this direction.

- **Four Quadrants.**

In an interview with Liesl Schoonwinkel, an accredited brain practitioner and member of the South African Foundation of Creativity, the quadrants and personality differences were further classified as follows:

- **Left (L) Front (1).**

Left (L) front (1) (hereafter L1) persons are fact-based, they are very analytical, and they like to reason and analyse matters. They argue and reason about things and continue analysing and digging deeper until they find the essence or what it is all about. They are also good at memorising facts because they are knowledge hungry individuals. In terms of careers, they like to work with finances, not accounting, and excel in taking financial decisions in the financial management field. They may well also be technically and scientifically inclined, although they are not averse to work with instruments and in a technical or laboratory type of environment. They are perfectionists by nature, and they can be authoritarian. They like external control and do not impart complete accountability and control with delegating tasks, since they keep on monitoring, asking, and checking up.

- **Left (L) Rear (2).**

The left (L) rear (2) (hereafter L2) persons have a predilection for systems and structure. They perform tasks in a step by step manner, and like to plan ahead. They are well organised and their environments are usually tidy and organised because of their categorised way of thinking. The L2s are fond of detail and are able to handle an accumulation of detail simultaneously, whilst they plan step by step. They have a strong preference for being prepared for events. They are strongly averse to

surprises and do not wish to be caught off-guard, and for this reason they are fairly change-resistant. They like to continue doing something in the same way it has always been done, in other words they have a strong preference for tried-and-tested methods.

- **Right (R) Front (1).**

Right (R) front (1) (hereafter R1) persons deal with the big picture. They shy away from any kind of detail. In fact, they rapidly become bored with detail. One should not give them any repetitive or routine work. They have good imaginations and enjoy inventing or creating new matters and ideas. They would typically drift off and imagine that they are somewhere else when they become bored, which happens very easily. In combination with their good imaginations they have a need of variety to be permanently challenged by new tests, also since they are not fond of prescriptions and rigid structures. This means that they are ideal for careers where a creative spirit is needed to create something completely new, where nothing may have existed until persons with this personality trait conjure up some novel idea, vision, plan and concept because there are no pre-determining rules that restrict them. They are able to do so because they think in big pictures, they can have wonderful visions and see the end-result, but it should be added that they are not process-driven. They visualise the plan and they can see themselves at the end of the project, however without attending to the detail to get there.

- **Right (R) Rear (2).**

The right (R) rear (2) (hereafter R2) persons constitute the core of the people-quadrant. These persons have a natural instinct of who people are, how to approach them, and what their points of view are. Moreover, they are tolerant of people and allow others to be different from them, but yet

they have an instinctive understanding of such differences. They excel in interpersonal relations, team building, reaching consensus, negotiations, and binding partners together, coming to some form of agreement, insight and understanding to a point where all are able to agree to actually accept a different point of view, although it may have been contrary to one's initial position. They need to interact with people. One needs to be aware that they experience conflict situations as very destructive for them as human beings. R2s would be devastated as human beings should they have to live in conflict for prolonged periods. There needs to be a resolution and peace needs to return where we all may live happily together

- **The Investor and Entrepreneur.**

Against the above background, it is important being able to analyse the investor and the entrepreneur in understanding the differences in their respective thinking preferences and how each one experiences his/her specific situation. It is important to realise that nobody falls into one quadrant only, since personality traits are always manifested in combination with another dominant quadrant. Each entrepreneur and investor would, therefore, be a unique person, but would in broad terms appear as in the analysis below. The different brain preferences and the influence on a person's personality should be fully understood by the investor, founder and the management team. Every person has at least two dominant quadrants, followed by the lesser quadrants. To utilise the strong points and the ability to combine the personalities into a team, may well ensure the success of a venture. The brain preference differences between the entrepreneur and the investor could easily lead to conflict that should be managed positively. One obvious way of managing this conflict is to understand the differences between the two parties, as explained below.

- **The Investor.**

The traditional banker, investor and fund manager is an L1 / L2 combination. The L1s are precise people who need to understand their economic environment and analyse what exactly their risk, their perceived opportunities and threats would be. Before they would consider investing their money, they perform an encompassing task of analysing what exactly they should invest in, what market segment they should be entering and exactly who the client or the customer should be, They wish to retain control over their investments because L1s are external authority driven. They are completely clinical about this analysis, unless they have R2 characteristics. They will not analyse the other person involved or the person's situation, dire straits or need for funding. These are not considerations that they take into account when they analyse the possibility of their investment. Ultimately it all revolves around money, economy, risk, and the opportunity cost of any risks.

- **The Entrepreneur.**

An entrepreneur typically has R1-characteristics, which could in turn be combined with any other quadrant. Should an entrepreneur venture into training needs, then he/she may well be a R1/R2-combination. If the entrepreneur ventures into a financial or a completely new engineering field, the best would be a R1/L1-combination. It is apparent that the R1-characteristics are always present in such an entrepreneur's personality. This kind of entrepreneur deals in big pictures, with no risk aversion, in fact, the word "risk" is never considered and the opportunities in the market are automatically identified. They are solution finders, always searching for new challenges. This kind of entrepreneur wants to be permanently challenged. Challenges are accompanied by trying something that has never been done before. R1s are averse to boundaries,

they are very happy to deviate completely from established entrenched systems and to do something that is in direct opposition to the way it was traditionally done before. This approach may seem like encompassing a huge risk. However, to be creative one should have a decided preference for operating outside the set boundaries. RIs will go out and discover the world and try new things, opening up the universe to us in all possible fields. They are typically the inventors, the creators, the discoverers, the entrepreneurs. They establish new enterprises, new ideas in the market, new products, new services, and new ways of doing something that has not been done before. They are innovative and are willing to take risks, they like to be challenged and they love the rush of adrenaline, the excitement of being involved in something that is entirely new. In brief it may be said that entrepreneurs are hunters, they are interested in the “kill” and not in the administration that has to be followed. The entrepreneur needs someone else to do follow-up work, maintain the systems, controls and structures.

- **Reasons for Conflict between Investor and Entrepreneur.**

The entrepreneur has a vision and a dream and runs with this dream or the vision at full pace, simultaneously working at a number of aspects that need to be in place. He avoids paying attention to detail, systems or structures and does not necessarily perform tasks in sequence, since he has a clear vision of the end goal. The investor, L1/L2, is a person who prefers not to do things at full pace, or galloping past all of the detail. Investors sit down and they analyse. They structure and they sequence. They are the ones who would meticulously thrash out the plan in its entirety and then for each of the components of the plan they would have a step by step action plan of how to put that plan into practice. When these two personalities are members of one team, they are very likely to face a head-on-collision without a mediator. The entrepreneur is passionate about

his venture. He is thrilled, excited, and cannot wait to make something happen. On the other hand the L2-person would look at the details and not be ready to proceed. The investor will not proceed before all the structures, plans, sequences and steps are meticulously laid out on paper knowing exactly what his first or next step is going to be. The differences in approach between the investor and entrepreneur may lead to frustration and conflict which needs to be managed for the benefit of the venture. The role of the CEO or mediator will be to manage the entrepreneur and the investor's approaches and ideas into a workable plan where neither of the investor nor the entrepreneur will lose their drive or passion.

- **Resolving the Conflict between the Investor and the Entrepreneur.**

The conflict between the entrepreneur and the investor is primarily vested in the personality differences as described above. The intensity of the conflict would obviously vary from venture to venture. The best manner to resolve such a possible conflict scenario is the intervention of a third party. This may be a person who is neutral and does not have a vested interest with either party. It may be a person who ideally would have an L1/R2 profile. The L1 would typically analyse the situation objectively and with little or no emotion decides what to do to resolve the conflict. The R2 quadrant gives persons the ability to be negotiators and to reach decisions by consensus. They are people focused and have the ability to tolerate others who have different profiles and preferences. They would better understand both the investor and the entrepreneur and their needs, and would then devise the structure and the system within which both of these personality traits are able to contribute their unique strengths. They would create a neutral arena for these divergent persons to meet and combine forces.

Gladstone and Gladstone, (2004: 53) state that the venture capitalist most often invests with an entrepreneur who has a personality that is compatible with his own. Many good ventures will be discarded if the above policy is applied. Personality differences can be overcome by a mediator's presence.

The specific characteristics of an entrepreneur that normally contribute most to the success of a venture are discussed next.

3.4.3 Characteristics of the Entrepreneur.

Broader characteristics of the entrepreneur may be divided into two sets of characteristics, as described by Gladstone and Gladstone, (2004: 52 to 54).

- Mental characteristics (need for achievement, need for power, risk preferences etc.) and
- Behavioural characteristics (determination, resourcefulness, sense of urgency).

The following characteristics have contributed most to the success of successive generations of entrepreneurs over the years (Gladstone and Gladstone, 2004: 52 to 54), (Camp, 2002: 36 to 38) as well as (Hill and Dee, 2002: 75 to 76):

- **Need for Achievement.** Every study of entrepreneurial individuals has demonstrated that entrepreneurs have a specific need to achieve. They are very competitive and an urge to be first.
- **High Need for Autonomy and Power.** Entrepreneurs need to be independent and autonomous, they want to dominate the situation and be in full control. As a result, some entrepreneurs may have poor interpersonal skills.

- **High Degree of Self-Confidence.** Most entrepreneurs are very confident about what they are doing. They believe in themselves.
- **High Tolerance for Ambiguity.** Entrepreneurs are non-conformists by nature and have no strong aversion to change as long as it suits their objectives. Most entrepreneurs are creative and interested in almost any subject matter.
- **Need to Assume Only Moderate Risk.** Entrepreneurs are moderate risk takers as perceived by the entrepreneur. The investor may classify this risk as high, but according to the entrepreneur the risk is on a moderate level.
- **High Degree of Determination.** Entrepreneurs are determined and have a strong desire to succeed.
- **High Degree of Resourcefulness.** When problems occur, entrepreneurs are good at finding solutions.
- **Sense of Urgency.** Entrepreneurs have a strong sense of urgency, always trying to beat the clock. They try to squeeze as many activities as possible into each hour of the day, as time is money.
- **Knowing what is Reality.** The entrepreneur knows the need to stay level headed and to know how and to which situation to react to.
- **High Level of Energy.** Successful entrepreneurs are typically energetic, which is a prerequisite for success.
- **Mental Stamina.** Along with physical energy, most entrepreneurs have tremendous mental stamina. They are able to think about a problem and work hard for hours to attempt to resolve it.

- **Strong Communication Skills.** Entrepreneurs normally have good communications skills and have the ability to persuade and convince people.
- **High Degree of Integrity.** Entrepreneurs are mostly honest in their approach to the world and will approach people in this way although there are entrepreneurs that will try to exploit people.

It is evident that the entrepreneur and investor are both individuals with specific personalities and characteristics that should supplement each other in order for a venture to succeed. Both the entrepreneur and the investor need to appreciate that the other party shares his or her eventual aim in making the venture a success. They should throughout be aware of their differences and use the synergy that this creates to obtain a competitive advantage. The mediator may help to create a perfect balance and manage the transfer of knowledge and skills that is so critical. One can never ignore differences, but they should be used in a positive way for the benefit of the venture. Psychological assessment tests could assist the investor and the entrepreneur to be aware of their personality differences, including the strong and weak points of the whole management team. This analysis will assist the mediator to address differences before they become problems. Successful entrepreneurs and investors have the ability to see and appreciate the broader picture.

3.5 Mentor Capitalist.

The role of the mentor is a prerequisite for the success of a venture. Such a mentor could come from the ranks of the investor, non-executive director, director or CEO. In a study by Onset Ventures, Camp, (2002: 62), it is apparent that the major reason for the failure of early stage companies is the lack of a mentor. Such companies are generally able to gain substantial value from a mentor, who is someone with experience. (Camp, 2002: 62) Value is not only added to early stage companies, but to any company if the management team and advisory board are constituted in a balanced fashion. The management team, advisory board, directors and non-executive directors have to be able to keep abreast with the needs of the company, whilst the shareholders and investors should be aware of this

aspect and they should bring about any changes as and when these may become necessary. The investors and shareholders should be progressive, thereby facilitating the process of affecting changes sooner rather than later.

During the last few years, mentor capitalism and other forms of support groups for entrepreneurs became more pronounced in the USA. Investors would typically realise that their investment success rate could increase substantially, should they mentor the ventures in which they invest, thereby reducing the failure rate. Consequently, the investors increase the rate of return on funds invested and, therefore, increase their own rate of return.

3.5.1 New Developments.

- **Corporate Venturing.** Angela Sormani reports in the European Venture Capital Journal of February 2006, (2006: 5 to 6) that corporate venturing is returning, but with a new approach that draws on the experience of traditional venture capitalists either in a formal or informal capacity. The technology giant IBM launched a venture capital advisory council constituted by venture capitalists from some of the world's leading venture capital firms. The aim of this council is to mentor their ventures. Many corporates are following suit, such as British Telecommunication, Dell, Intel and Motorola (Hill and Power, 2002: 93).
- **Return of Seed Capital Investment.** At the end of the 1990s, the seed capital market raised billions of dollars in the United States but overall with limited success. In 2004, firms like Kleiner Perkins Caufield and Byers, Charles River Ventures and Battery Ventures, moved away from seeking billions and rather raised smaller amounts that led to a more hands-on approach and managing smaller portfolios. The outcome is that investors are becoming so involved in the venture

that increasing numbers are attending customer meetings to understand the market and the product. The Woodside Fund aims to introduce as many as three partners into a single deal to ensure that there is a hands-on approach in all stages of the mentoring process, especially when it comes to recruiting executives. The Fund interviewed for example 22 candidates for a CEO position in one of its portfolio companies. This intense involvement increases the venture's chances of success. (Anonymous A, 2005: 40 - 43)

- **Mastermind Groups.** An entrepreneurship expert has formed and runs the Toronto Entrepreneur Mastermind Groups, consisting of groups of small business owners who meet on a regular basis to collaborate, brainstorm and provide support for each other's goals. The concept of mastermind groups is currently seeing a rise in popularity. It should be remembered that this phenomenon is not something new. Napoleon Hill first described the idea in his 1937 book, "Think and Grow Rich". Andrew Carnegie, a self-made steel billionaire, commissioned Napoleon Hill to interview the most successful business people of the time and discover what their secrets were. The answer lay in mastermind groups. One may also term this an expanded soundboard. (Carmichael, 2006: 1 - 2)
- **The Role of Intermediaries.** In the USA the quality of proposed projects presented to the venture capital funds started to decrease, with a result that intermediaries started to form a conduit between the investor and the entrepreneur. The evaluation process by the intermediaries increased the quality of the proposed projects, including the competencies of the management team. Referrals from intermediaries have an acceptance rate of twice the rate of unsolicited deals. The effectiveness of the intermediary's role as deal facilitator has important implications for the allocated investment efficiency of

the venture capital market. The intermediaries render two distinct client services to the investor and entrepreneur, namely:

- negotiating a purchase from the vendor, and
- identifying and helping to select, with their management clients, the most attractive or appropriate venture capital partner.

The number of ventures searching for funding in the United States of America is overwhelming since they allow intermediaries to pre-select ventures and presenting ventures to those venture capital funds with the appetite for the specific market that the venture wishes to explore. This decreases the time, and increases the effectiveness needed to raise funding. In 1992 a survey of 21 early stage investors showed that of the 1410 applications they received 47% were referrals from intermediaries. (Murray and Wright, 1996: 14)

- **Education.** External directors or non-executive directors are in a position to play an important role in the executive learning process. They are expected to bring experience, knowledge, discipline, help with strategic planning, contacts, and planning skills and many other intangible benefits to the venture company. It was found in research conducted by Argyris and Schon in 1978, (Deakins, O'Neill and Mileham, 2000: 319), that a company may not develop unless the entrepreneur is able to learn. The acquisition of knowledge includes the learning and transfer of tacit and explicit knowledge. The development of the entrepreneur will be higher if the interaction between the entrepreneur and the external director is good. Learning more from experience implies bringing knowledge, skills, values and attributes together to interact in the learning process (Deakins, O'Neill and Mileham, 2000: 319). China's economic success in the past few years resulted from the release of the entrepreneurial potential inherent

in the business sector. China developed entrepreneurship education as a perceived and integral part of competence and capability building and introduced the modules, “corporate entrepreneurship” and “venture capital management” into their MBA studies. This resulted in an increased economic expansion, with a growth of 8 to 10 % per annum and development mainly in the small and medium enterprise market led by people trained in entrepreneurship and venture capital principles. (Li, Yuli and Matlay, 2003: 501)

The venture capital and angel investing market is an evolutionary market, moving in the direction of mentor capitalism, and aimed at increasing the overall venture capital success rate. The developments in these markets indicate that it is important to have a hands-on approach to improve the opportunity for success. An Italian businessman, Carmelo Pistorio, operating in Singapore, is an angel investor with hands-on entrepreneurial experience to guide his seed companies. He stated that money is not the most difficult factor for a Singapore based start-up to access, but rather finding experienced entrepreneurs to guide it along the bumpy road from concept to becoming a company. Pistorio has a 90% success rate in the ventures in which he invested; far above the normal accepted average of about 20 to 40% (Anonymous D, 2004: 1 to 2). Mentor capitalism demands much more time and effort from the investor, but the rewards are commensurately much better. Further development in the venture and angel investing market will depend on the further development of the mentor capitalism approach, especially in those countries, such as South Africa, where venture capitalism and angel investing is not a well-established way of financing new ventures.

3.6 Conclusions.

The question posed in Chapter 2 was whether investor, venture capitalist, angel investor, family and friends and directors of a new venture have an important role to play regarding the success of the new venture. Why there is such a high rate of unsuccessful venture capital investments is another question to be answered. Venture capital

investment is a very important investment vehicle, highlighted by the fact that as many as 70 % of all new job opportunities created in the USA in the 1980s came about through venture capital investments. (Bartlett, 1988: 11) (Venture capital investment refers to the market segment that includes private equity investment, venture capitalist, angel investors and other investors, such as family and friends). Investing in the venture capital market is a very sophisticated and involved action. The investor has to ensure that he knows what he is in for and that the investment is made with the right expectations. The entrepreneur, on the other hand, should also realise that, although it is his original idea, he may have to part to some extent from the venture in order to achieve his and the investors' objectives.

The success of the venture depends on the inputs received from both the investor and the entrepreneur. The investor and the board of directors, as well as the management team, should be chosen and appointed with considerable care. It is a give-and-take situation where none of the parties involved should try to dominate the other. The difference in personalities and strengths creates the ideal platform for conflict, but is also the one aspect that may lay the basis for a strong combination. Many venture capitalists have realised that they cannot only be money managers and that they need additional expertise, knowledge and skills that would enhance the venture's chances of success. An angel investor, Carmelo Pistorio from Singapore, has realised this and increased his success rate to a 90 percent level. Many other initiatives have been implemented over the years, such as the concept of mastermind groups and the way corporates are becoming involved in this market. The relationship between the investor, shareholders, directors, non-executive directors, the CEO, entrepreneur and the management team could be compared with the process of mixing concrete. One could add all the necessary ingredients into the concrete mixer, but without water the mixture will merely remain dry ingredients with no strength. Each ingredient may have wonderful qualities, but without the ability to be combined in concrete, such ingredients have no inherent strength. Each ingredient is important and is needed to achieve the goal. The management team and all other parties involved should have the ability to work cohesively in order to demonstrate their real strength.

All the influences, from the role of the investor, entrepreneur, director and many others, as reviewed in Chapter 2 and 3 determine the success of the venture. The influence of each one of these role players creates important building blocks, including the transfer of knowledge and skills by each role player, to build the ventures as foreseen by the entrepreneur and the investor.

CHAPTER 4 RESEARCH IN THE UNITED STATES OF AMERICA AND EUROPE

4.1 Introduction.

The electronic age has simultaneously made gathering of information easier and also much more difficult. It might be easier to contact potential respondents electronically, but the respondents are much more reluctant to complete questionnaires than in the past. This phenomenon is mainly caused by the overflow of questionnaires reaching potential respondents. Some companies have adopted a policy not to complete questionnaires if they do not emanate from their association or university to which they subscribe. The above is understandable if taken into consideration that a vast amount of information is gathered that could be used by other researchers, but which are included in questionnaires distributed by other researchers. Most of the researched information is published and may be used in other research reports. Consequently the areas not researched before regarding venture capital associations, angel capital associations and venture capital funds, now need to be identified and researched independently. The National Venture Capital Association (NVCA) yearbook compiled by PricewaterhouseCoopers and the NVCA, the European Venture Capital Association (EVCA) yearbook compiled by PricewaterhouseCoopers and Thomson™ and KPMG and the South African Venture Capital and Private Equity Association (SAVCA) surveys compiled by KPMG and SAVCA are some of the published research papers that are used in this chapter to provide research answers emanating from the USA, Europe and to a lesser extent from South Africa.

4.2 Selection.

The process of selecting which specific countries to include in the international sample is important to ensure that the countries selected represent the majority of the funds raised and invested globally.

The private equity industry that includes venture capital funds, but excludes angel investments, is used as the basis for the selection of the countries to be included to provide an overall global overview of the current venture capital activities. Mathews and Fourie, (2007: 20) rank the top 20 countries per investment activities in table 4.1 and the fund raising activities in table 4.2. These rankings are supported by Anonymous F, (2007: 17). Own calculations were used to determine the percentage investment of the total investment made or funds raised by the top ranked countries. A total of 83.72% of the investment made by the top 20 ranking countries are made by countries that include the USA and Europe.

Table 4.1. Top 20 Countries Ranked According to Investment Activities.

	Country	Investments (Rbn)	Percentage of total investment in top 20 countries
1	USA	268.50	35.77%
2	UK	188.60	25.12%
3	France	57.70	7.69%
4	Japan	45.50	6.06%
5	Sweden	23.70	3.16%
6	Germany	21.30	2.84%
7	Spain	21.10	2.81%
8	Netherlands	18.50	2.46%
9	Italy	17.30	2.30%
10	Australia	14.00	1.86%
11	China	13.30	1.77%
12	Korea	10.10	1.35%
13	India	8.60	1.15%
14	Denmark	8.40	1.12%
15	Singapore	8.30	1.11%
16	Canada	7.70	1.03%
17	South Africa	6.00	0.80%
18	Malaysia	4.90	0.65%
19	Israel	3.80	0.51%
20	Norway	3.40	0.45%

Source: Mathews and Fourie, 2007: 20 (and own calculation).

The fund raising activity for the top 20 ranked countries in table 4.2 differs from table 4.1 where 93.44% of funds raised are raised in Europe and the USA.

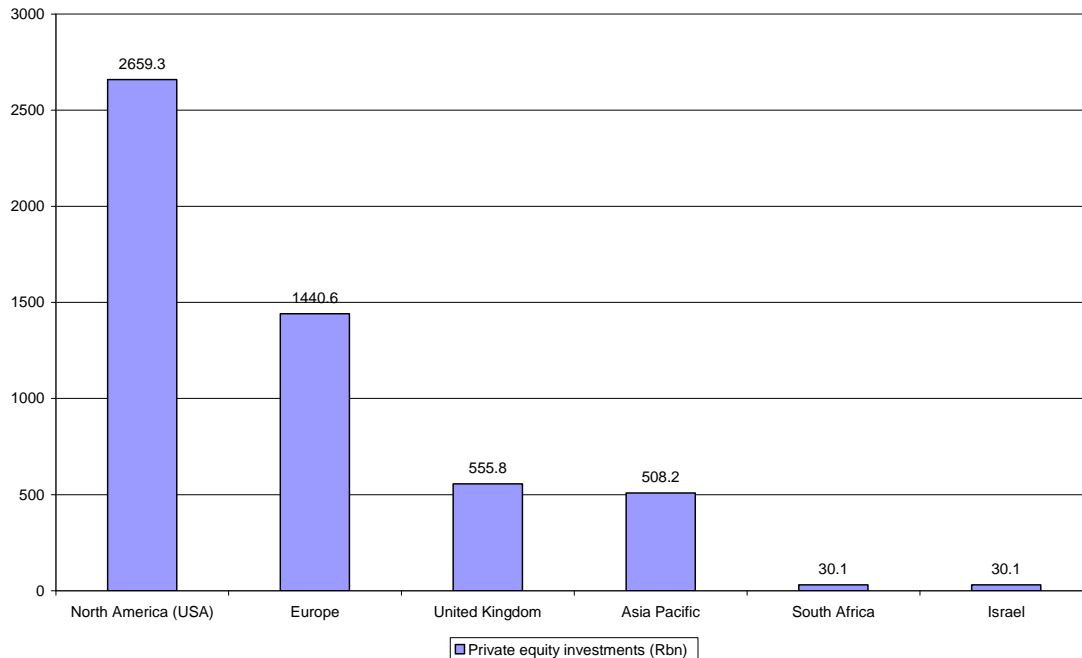
Table 4.2. Top 20 Countries Ranked According to Fund Raising Activities.

	Country	Investments (Rbn)	Percentage of total funds raised in top 20 countries
1	USA	636.20	49.36%
2	UK	361.20	28.03%
3	France	90.60	7.03%
4	Japan	35.70	2.77%
5	Germany	22.70	1.76%
6	Netherlands	19.30	1.50%
7	Sweden	15.20	1.18%
8	Australia	12.00	0.93%
9	Switzerland	11.80	0.92%
10	South Africa	11.20	0.87%
11	Italy	10.60	0.82%
12	CE Europe	10.20	0.79%
13	Israel	8.20	0.64%
14	Spain	8.10	0.63%
15	Denmark	7.90	0.61%
16	Canada	7.30	0.57%
17	Singapore	5.90	0.46%
18	Norway	5.40	0.42%
19	Finland	5.00	0.39%
20	India	4.30	0.33%

Source: Mathews and Fourie, 2007: 20 (and own calculation).

Before a final selection of which countries or group of countries to be included in the international sample was made, the size of the international private equity market was taken into account to confirm the calculations done in tables 4.1 and 4.2. Figure 4.1 gives a graphical display of the global equity markets as reflected by Mathews and Fourie, (2007: 19).

Figure 4.1. Size of the International Private Equity Markets.



Source: Mathews and Fourie, 2007: 19.

The data were converted at the same exchange rate of \$1 = R7.00 as per Mathews and Fourie, (2007: 19).

The data in tables 4.1 and 4.2 and in figure 4.1 indicate that more than 80% of all global investment activities in the private equity market would be included if the USA and Europe are selected as the areas to be covered in this study. The impact of the other countries is not so significant and may, therefore, be excluded from this research. South Africa is included because of the relevance to the stated objectives of this study.

4.3 Private Equity.

Private equity can be defined as an asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange (Mathews and Fourie, 2007: 8 - 9). Private equity has grown from a non-event in Europe with an investment value of \$15 billion 15 years ago to a very popular asset class at present. In research by Metrick

and Yasuda, (2007: 2), it was found that private equity funds manage approximately \$1 trillion(USD) of investment capital. Private equity was seen to be a very risky investment, but in the 1990s European investors began to react favourably to this new asset class. Private equity was generating impressive returns and the investors wanted to be part of that trend (Echarri and Coller, 2007: 21). Private equity invests funds normally into unlisted companies that hold large benefits to the beneficiary companies beside the funds invested. As stated by Mathews and Fourie (2007: 8) private equity investors have a considerable impact on productivity, skills development, national competitiveness and job creation, as they include the transfer and exchange of know-how and not only the flow of capital. The transfer of skills and knowledge is, according to the above, a critical element of any private equity investment. Most of the private equity funds worldwide are organised as listed companies with large institutional investors and wealthy individuals providing the bulk of the capital to be invested (Metrick and Yasuda, 2007: 2).

4.3.1 Investment Stages.

The definition of private equity investment as defined in paragraph 4.3 above differs from that of venture capital investment mainly in that private equity includes venture capital as a sub-class without detailing angel investing as a possible sub-class. It should be mentioned that angel investments are mostly done by wealthy individuals and, therefore, are excluded from this classification. Private equity investment may broadly be classified into three sub-classes, namely (Mathews and Fourie, 2007: 8 - 9):

- Venture capital funding,
- development capital, and
- buyout funding.

Table 4.3 sets out the terminology as defined above. The differentiation between the sub-classes is important to ensure that there is no confusion when venture capital investment is addressed and discussed.

Table 4.3 Private Equity Investment Stages.

Private equity category	Stages of business development	Typical application
Venture capital	Seed capital	Funding for research, evaluation and development of a concept or business before the business starts trading
	Start-up and early stage	Funding for new companies which have been in business for a short time.
Development capital	Expansion and development	Funding for growth and expansion of a company which is breaking even or trading profitability.
Buyout	Leverage buyout or buy-in.	Funding of a management or other leverage buyouts and buy-ins.
	Replacement capital	Funding for the purchase of existing shares in a company from other shareholders.

Source: Mathews and Fourie, 2007: 9.

4.3.2 Venture Capital.

Venture capital is defined in paragraph 1.1 by Benjamin and Margulis (2001: 7) as “the business of building businesses”. It is, therefore, an investment to create and grow new businesses. The NVCA (Anonymous E, 2007: 1) defines venture capital investment as:

- Financing of new and rapidly growing companies.
- Purchase of equity securities.
- Assisting in the development of new products and services.
- Adding value to the company through active participation.
- Taking higher risks with the expectation of higher rewards.

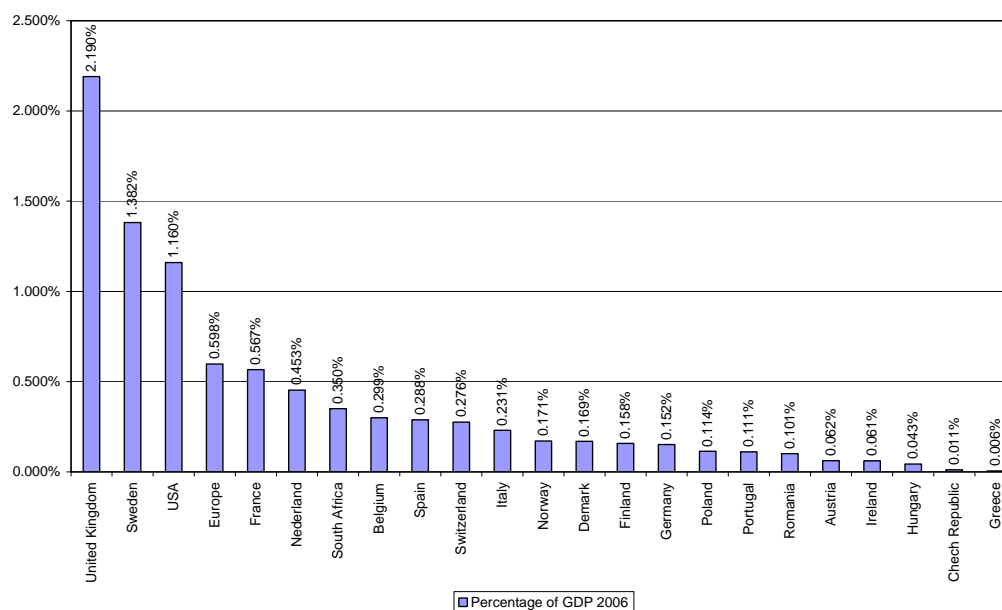
- Having a long-term orientation.

A buyout is strictly defined as a transaction in which the management acquires a business or company from the current shareholders with the support of private equity investors (Russel, 2005: 2). Although buyouts provide value to companies they cannot be regarded as a form of venture capital, because they do not create new or do not build growing businesses, since they merely replace current shareholders. This distinction has to be made because of the differences in approach in the USA and Europe. To draw a proper comparison between the USA and Europe, buyouts are excluded where possible in the rest of this chapter and venture capital will refer to the first two phases of investment as defined in table 4.3. Angel investments are totally excluded in the quantification of the magnitude of these investment classes because of the lack of quantifiable information regarding this investment class. The USA is the most advanced in the development and formalising of this investment class and even there quantifiable information is lacking.

4.3.3 Private Equity Investments.

Private equity investment is a growing market dominated by the USA with 66.63% (\$692 billion) of all private equity investments globally raised between 1998 and 2004, 24.46% (\$254 billion) in Europe, 6.64% (\$69 billion) in Asia Pacific, 1.25% (\$13 billion) and 1.01% (10.5 billion) respectively in the Middle East, Africa and Central and South America (Mathews and Fourie, 2007: 11). Investment in the private equity investment class differs from country to country. The investment intensity of a country should not only be measured by the quantity, but also by the percentage of GDP invested. Figure 4.2 indicates the investment made during 2006 per country in private equity, as a percentage of GDP.

Figure 4.2. Private Equity Investment as a Percentage of GDP in 2006.



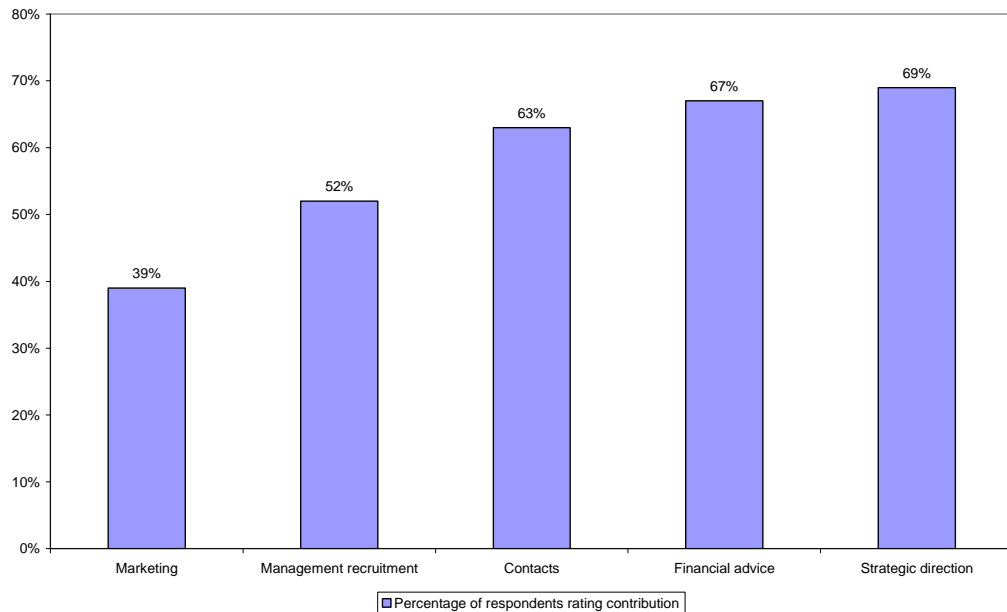
Source: Echarri and Coller, 2007: 57, adjusted.

Private equity-backed companies support and boost economies globally. Over a five year period to 2005/06 in the United Kingdom, the sales per annum in private equity-backed companies rose on average by 9% compared with 7% of the FTSE 100 and 5% of the FTSE mid-250 companies. Exports grew by 6% per annum compared with a national growth rate in the United Kingdom of 2%, whilst investment in private equity rose by 18% per annum compared with 1% nationally. (Selkirk, 2006: 3, 5)

Private equity-backed companies view the contribution to their businesses by private equity investors as positive. In addition to providing funding, private equity investors are also an important source of guidance and advice for the companies in which they invest. Respondents in the UK felt that their private equity investors contributed in ways other than the provision of funding as seen in figure 4.3. Overall the respondents identified strategic direction (69%), financial

advice (67%) and help with contacts (63%) as being key ways in which their investors had helped with the development of their business. (Selkirk, 2006: 14)

Figure 4.3 Non-Financial Contributions to Private-Backed Companies.



Source: Selkirk, 2006:14.

The above results are supported by research by Rosenstein and Bruno, (1993: 106) as shown in table 2.2 and Boussouara and Deakins, (2000: 325) as well as Deakins, O'Neill and Mileham, (2000: 215) as shown in table 2.4.

4.4 Fundraising and Investment.

4.4.1 Fundraising.

Funds are raised from corporate investors, private individuals, government agencies, banks, pension funds, insurance corporations, fund of funds, academic institutions, capital markets and other sources. More than 50% of the private equity investment in the USA emanates from institutional public and private

pension funds with the rest coming from endowments, foundations, insurance companies, banks, individuals and other entities who seek to diversify their portfolio with this investment class. (Anonymous E, 2007: 1)

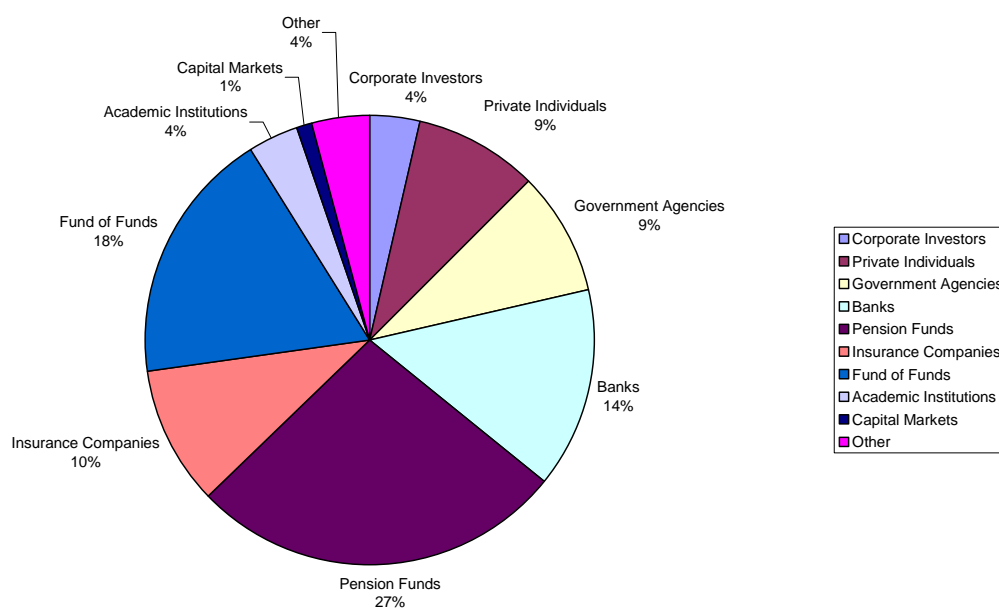
The sources of funds in Europe for the 2006 year and the last five years are displayed in table 4.4 below.

Table 4.4 Sources of Funds – Europe

	2006	5-year Total
Corporate Investors	3.70%	4.90%
Private Individuals	8.90%	7.10%
Government Agencies	8.70%	8.90%
Banks	14.40%	17.90%
Pension Funds	27.10%	23.90%
Insurance Companies	10.10%	10.80%
Fund of Funds	18.20%	15.60%
Academic Institutions	3.60%	2.70%
Capital Markets	1.20%	1.10%
Other	4.10%	7.10%
	100.00%	100.00%

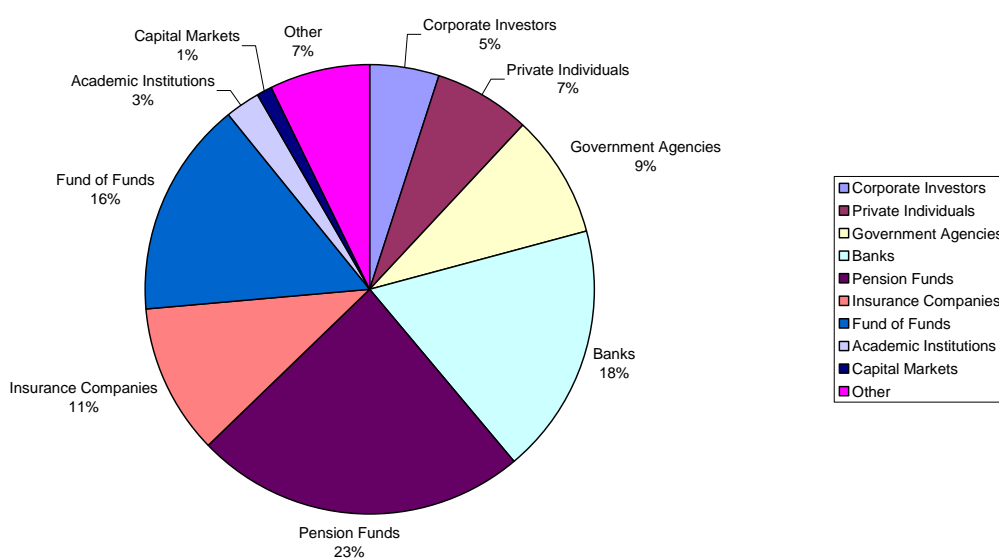
Source: Echarrri and Collier, 2007:63.

Figure 4.4 Sources of Funds – Europe 2006



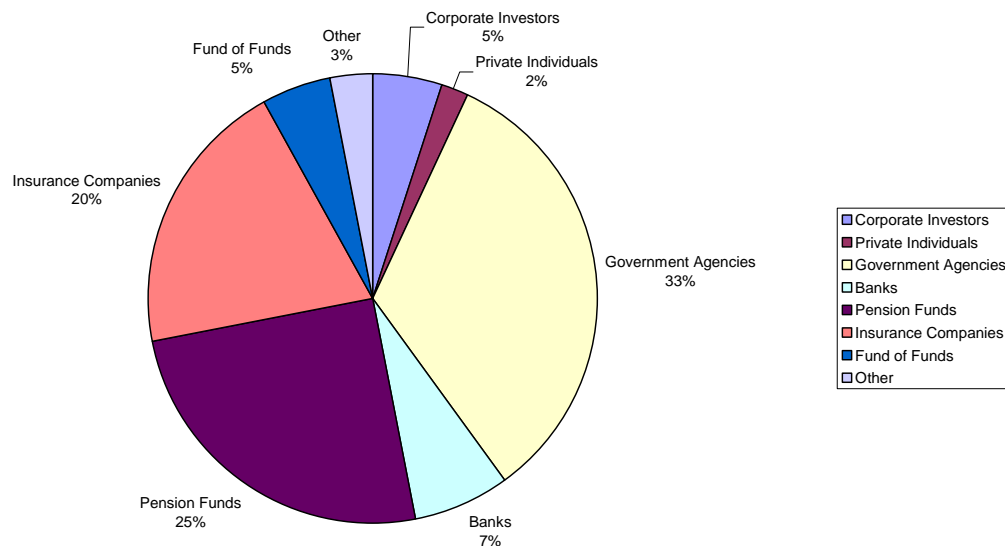
Source: Echarri and Coller, 2007:63.

Figure 4.5 Sources of Funds – Europe 5-Year Total.



Source: Echarri and Coller, 2007:63.

Figure 4.6 Sources of Funds – South Africa 2006.



Source: Mathews and Fourie, 2007: 23.

Government agencies, banks, pension funds and insurance companies dominate the supply of investments. The role that the public sector fulfils in the private equity market, combined with the role of corporate investors, indicate by implication that the source of funds dictate the contribution that will be made by the investors. The lack of practical business knowledge and experience of these investors may well contribute to the lack of success of any new venture. Institutional investors are fund managers and lack in most cases the practical experience (streetwise knowledge) and skills that contribute to the perceived high risk of venture capital investments.

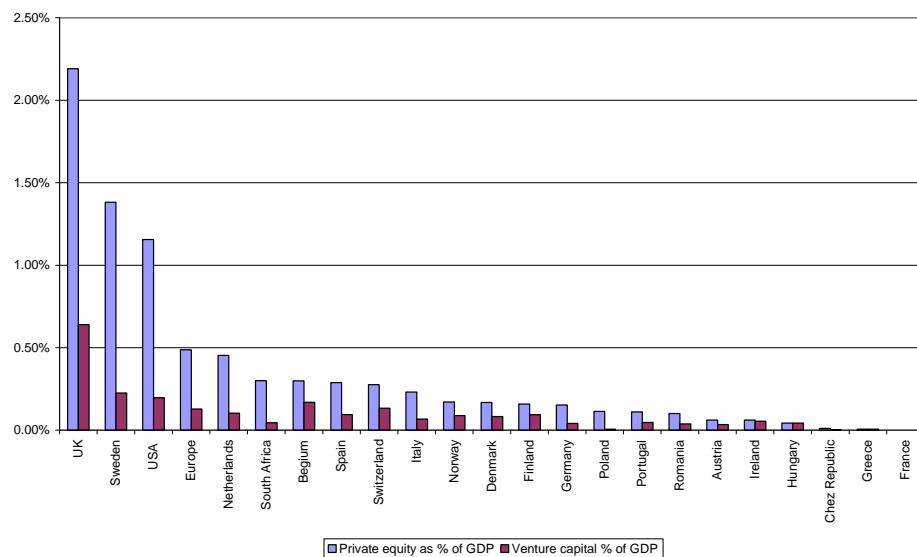
4.4.2 Investment.

The funds raised in the fundraising process described in section 4.4.1 are invested in private equity, venture capital and management buy-outs. The funds are distributed over different investment stages with specific investment preferences by the investment funds.

- **Venture Capital, Angel Investing and Private Equity.**

Buyouts do not form part of the creation of new businesses and, as stated previously, should be excluded or identified in the data under discussion. The value of angel investing in either of the USA, Europe or South Africa cannot be determined because of the lack of accurate information. The USA for one has a well-developed angel investing network where vast amounts of funds are invested that cannot be accounted for in the comparison illustrated in figure 4.6 below. The definition of private equity in South Africa and in Europe includes venture capital investment and management buy-outs. The United States of America exclude venture capital investment from the definition of private equity and treats venture capital as a separate way of investment. The difference in the private equity definition implies that a distinction should be made between private equity investment and venture capital investment, as referred to in table 4.3. Figure 4.2 indicates the relationship between private equity investment and the GDP of the specific country, whilst figure 4.7 compares venture capital with private equity investment in relation to the relevant countries' GDP.

Figure 4.7 Private Equity and Venture Capital as a Percentage of GDP.



Source: Echarri and Coller, 2007: 1 to 293 and own calculation.

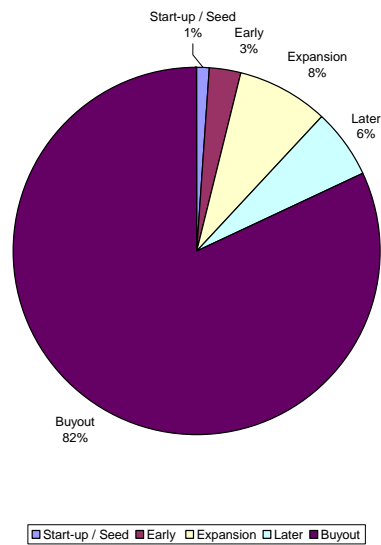
Venture capital relates at most to 30% of the private equity investment made in the UK, Sweden, USA, Netherlands and South Africa per year. Figure 4.7 shows the total private equity as opposed to venture capital investment. A very small percentage of private equity investors and even venture capital investors would be actively involved in a venture. This has a direct implication on the success of the venture. Mr Pistorio, a very successful venture capitalist from Singapore, is actively involved in the ventures in which he invests. His success rate, because of the transfer of skills and knowledge, is on average about 90% whilst the market average is around 20%. (Anonymous D, 2004: 1)

- **Distribution of Investment Funds.**

Buyout and mezzanine financing comprise the largest percentage of private equity funds invested in the USA, Europe and South Africa, as displayed in figure 4.5. Figures 4.8 to 4.10 reveal the distribution of funds

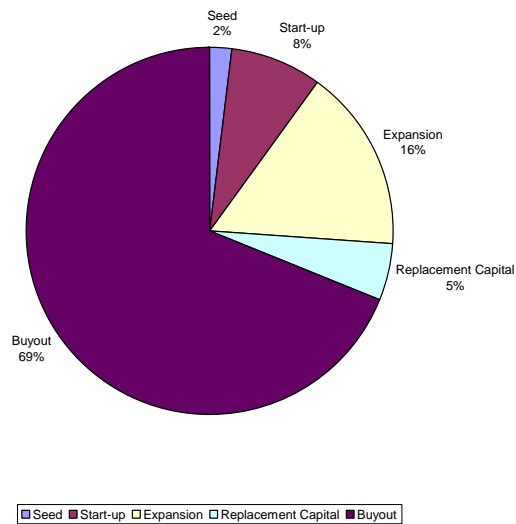
over different investment stages for 2006 in the USA, Europe and South Africa.

Figure 4.8 Distribution of Funds over Different Investment Stages in the USA for 2006.



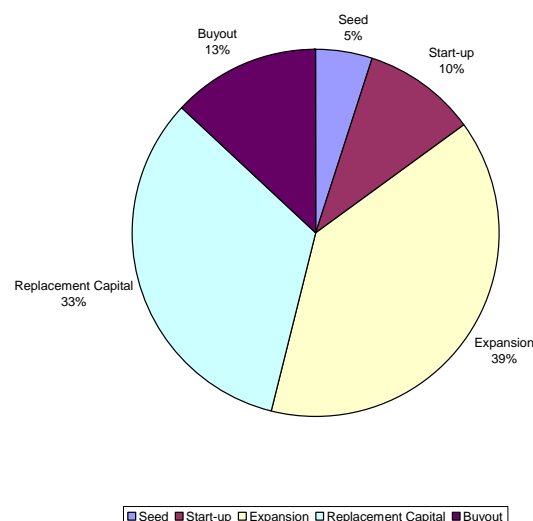
Source: Broderick and Heesen, 2007: 23, 30.

Figure 4.9 Distribution of Funds over Different Investment Stages in Europe for 2006.



Source: Echarri and Coller, 2007: 70.

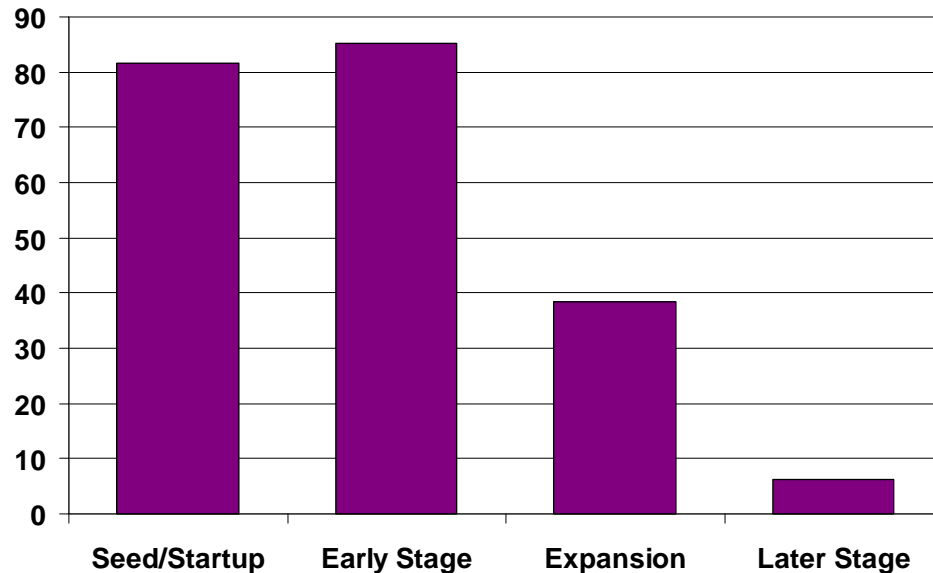
Figure 4.10 Distribution of Funds over Different Investment Stages in South Africa for 2006.



Source: Matthews and Fourie, 2007:29.

The distribution of funds across investments stages indicates very clearly that the private equity investors prefer not to invest in the early stage of an enterprise's development. The institutional investors, banks and insurance companies as the major source of funds, do not have the skills and knowledge to become involved in the early stages of investment. In this context the seed, start-up and, to a major extent, the expansion stages are deemed to be too risky. The changes that occurred, as indicated in figures 2.1 to 2.3, are quite clear in figures 4.8 to 4.10 above. Figure 4.8 shows that the USA's private equity investors do not prefer to invest in these early stages of a company's development. This by implication creates a major problem in the development of any enterprise where the chain of investment is broken. The probability of creating new businesses is restricted and the entrepreneur would need to obtain finance for his company at banks and other traditional entities, such as finance houses and the like, as indicated in figures 4.4 to 4.6. This gap in the investment market needs to be filled, and this is done in the USA by angel investors, as indicated in figure 2.3. The angel investment market is fairly well-organised in the USA and it fills the above gap in the market, as indicated by a survey done by the Angel Capital Association of the USA. The typical angel investor's preferred investment stages are the seed/start-up and early stage of an enterprise. Figure 4.11 shows the angel investor's preferred investment stages.

Figure 4.11 Angel Investors' Preferred Investment Stage – 2007/2008
(Percentage of group of angels)

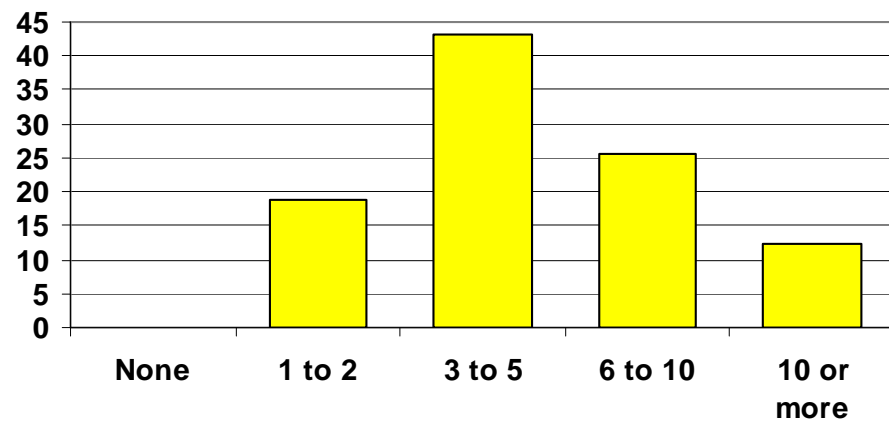


Source: Hudon, 2008: 6.

Angel investors are normally investors with previous experience who invest in ventures where they are able to become actively involved and they transfer their skills and knowledge to the venture and its management team.

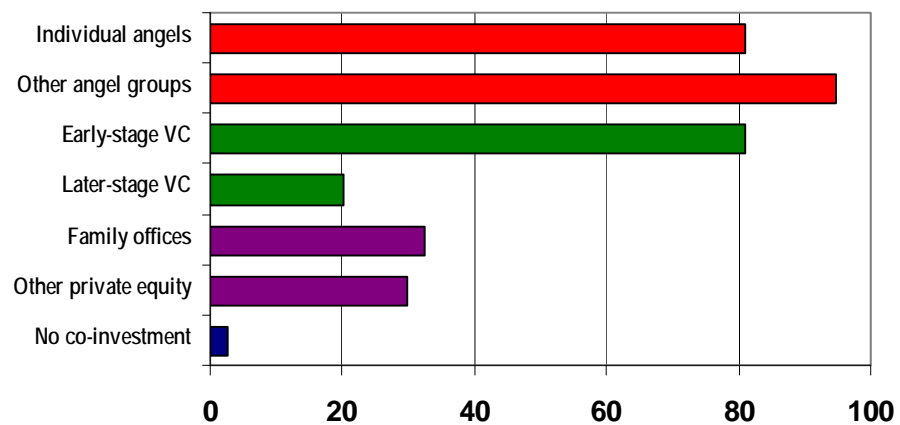
Angel investors and venture capitalists both have an important role to fulfil in the existence of a venture. Angel investors also prefer to encourage other angel investors to become involved to spread the risk and get a bigger skills pool involved in the investments required. Figure 4.12 and 4.13 shows in how many companies angel investors prefer to invest at any given time and whom they prefer to be their co-investors.

Figure 4.12 The Number of Companies in Which an Angel Investor Will Invest. (Percentage of group of angels)



Source: Hudson, (2008:10).

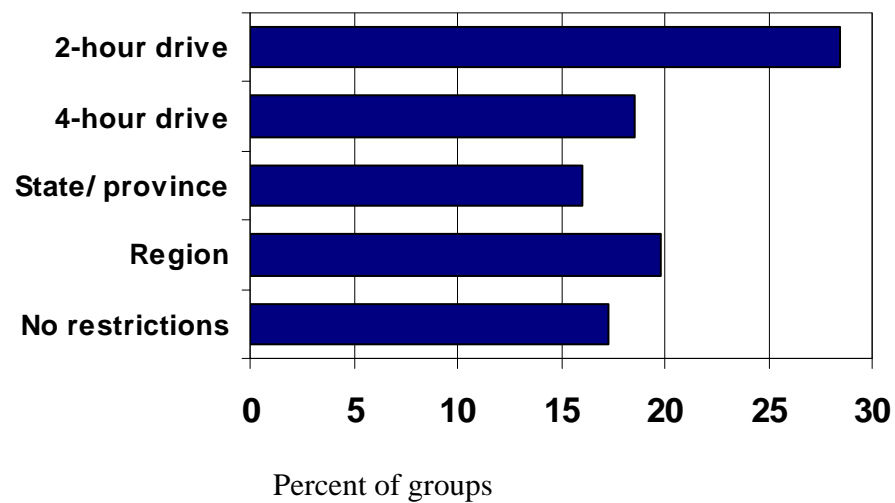
Figure 4.13 Angel's Co-Investment/ Follow-On Preferences.



Source: Hudson, 2008:10.

Angel investors also prefer to invest in ventures geographically close to where they are situated so as to be actively involved. The relevant company should be easily reachable and accessible.

Figure 4.14 Geography – Where do Groups of Angels Invest?



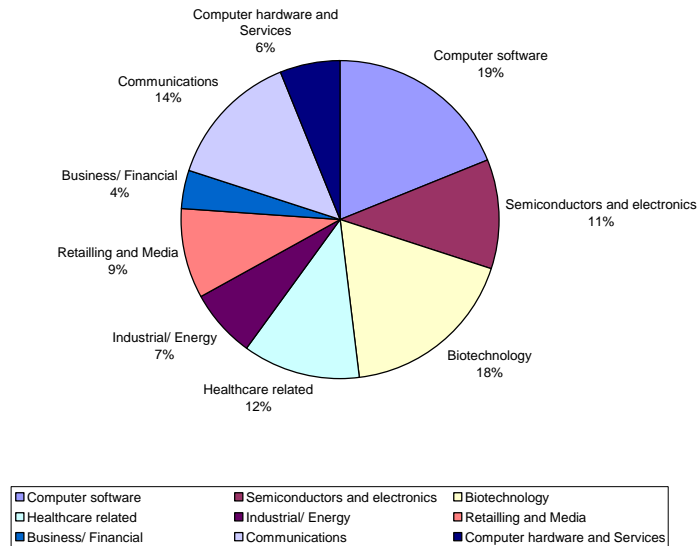
Source: Hudson, 2008:6.

The success of a venture is not only determined by the quality and uniqueness of a product alone, but the involvement of the investors in all the phases of investment as shown in figure 2.3 is important. Each type of investor fulfils an important role to ensure the success and risk reduction in a venture's lifespan.

- **Investment Preferences.**

High technology investments are currently receiving a significant portion of venture capital and angel investing. Venture capitalists and angel investors are traditionally interested in new exiting technology. In the USA venture capital investment in 2006 by industry sector is shown in figure 4.15 below.

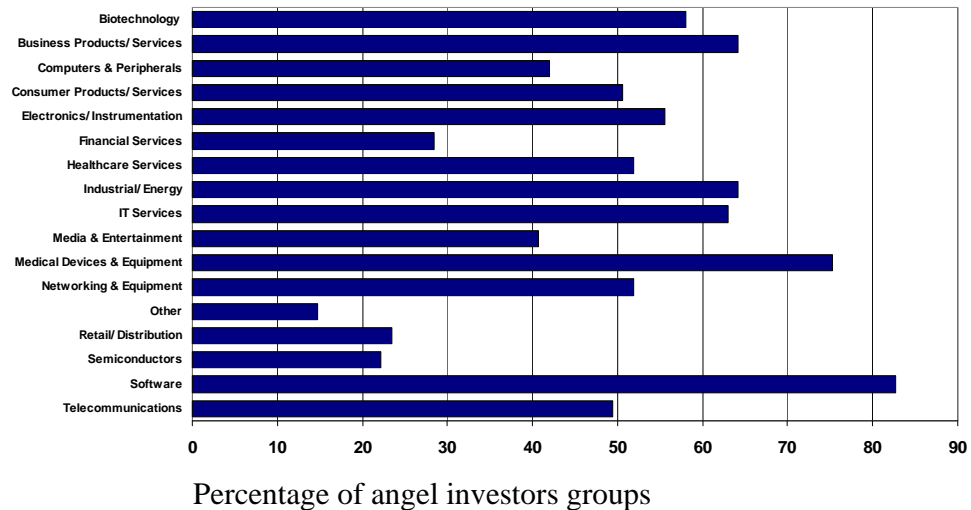
Figure 4.15 Venture Capital Investments in 2006 by Industry Sector.



Source Broderick and Heesen, 2007: 12.

The angel investor's investment preferences correlate with the venture capital market's preference. Figure 4.16 shows what the investment preference is of angel investors in the USA. The need for further finance will also have an effect on the angel investors' preference and they normally ensure that they invest in sectors that are of interest for other investors as well.

Figure 4.16 Angel Investors' Investment Preference.

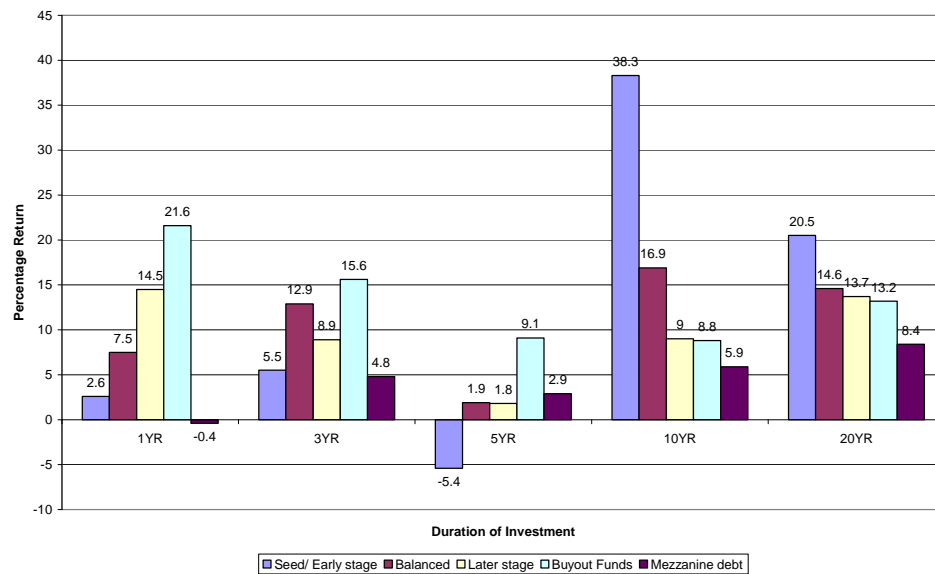


Source: Hudson, 2008: 4.

- **Performance.**

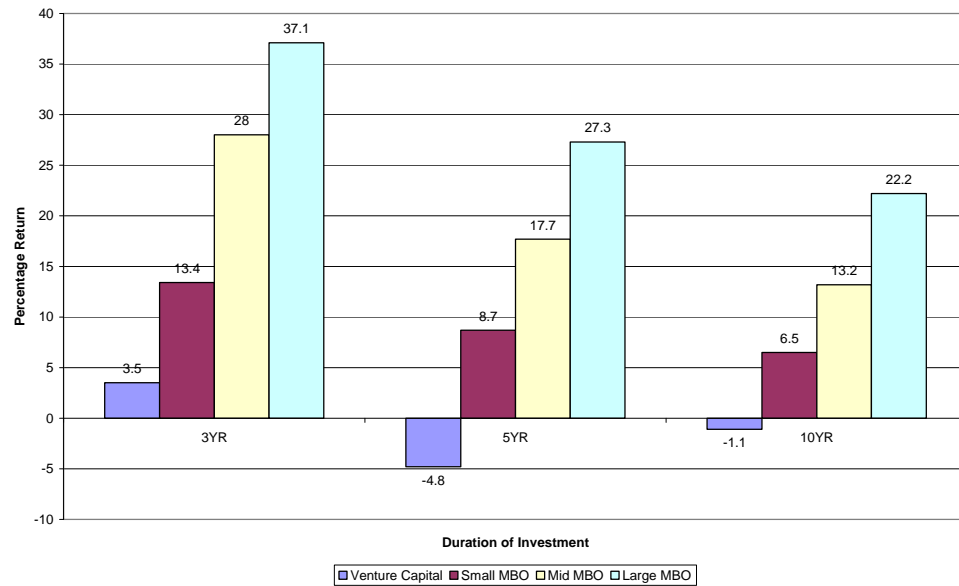
Performance measurement may be very difficult because of various external factors influencing the performance of a venture at any given time. Performance per stage has to be measured and, therefore, the internal rate of return (IRR) method is used. This method measures the actual return and excludes all the external factors that could influence the performance. Figures 4.17 and 4.18 reflect the performance of private equity funds in the USA and in the United Kingdom.

Figure 4.17 Performance of Private Equity Funds in the USA.



Source: Broderick and Heesen, 2007: 13.

Figure 4.18 Performance of Private Equity Funds in the United Kingdom.

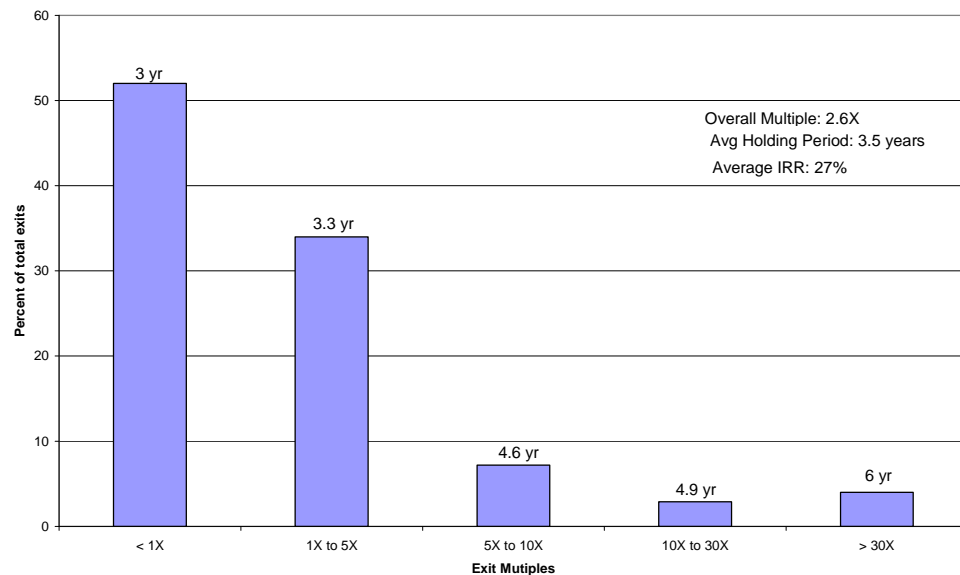


Source: Kolade, 2007: 9.

Figures 4.17 and 4.18 clearly indicate the perceived risk and low returns that may be expected from the venture capital market in the early stages of

investment. This assertion is, however, not totally true, because the role of angel investors and consequently the role of the investor in transferring skills and knowledge are excluded. The average IRR that angel investors achieve in these early stages is 27% as researched by Wiltbank and Boeker (2007: 3 to 9). The effect of the transfer of knowledge and skills, proper due diligence, relationship of investor to industry and the involvement of venture capital investment combined with angel investing is shown in figures 4.19 to 4.23.

Figure 4.19 Distribution of Returns by Venture Investments.



Source: Wiltbank and Boeker, 2007: 3.

The risk of venture investment will be reduced whilst the return expected would be increased by spending time and money on a thorough due diligence. The expected return on a low due diligence, or downscaled due diligence, is 1.1 times, an internal rate of return of 6 to 8%, with an exit period of 3.4 years. The multiples, which are defined as the multiple of the investment received on exit, imply that a certain internal rate of return, as per table 4.5, will be achieved over a specific period of time (Echarri and Coller, 2007: 1 and Coller Capital, 2007).

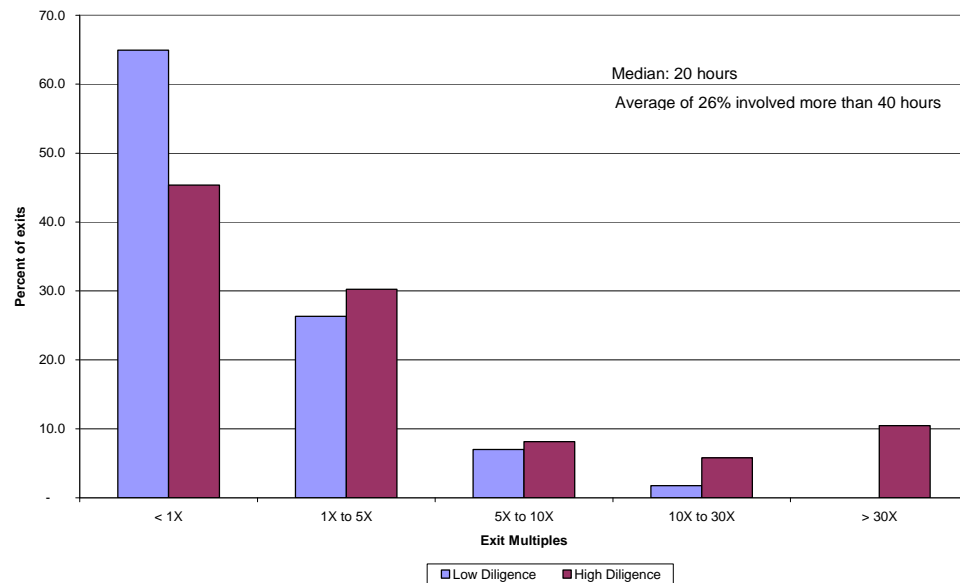
Table 4.5 Internal Rate of Return per Multiple.

INTERNAL RATE OF RETURN													
Multiple	0.5X	1.25X	1.5X	1.75X	2X	2.5X	3X	4X	5X	6X	7X	8X	10X
Year 2	-29	12	22	32	41	58	73	100	124	145	165	183	216
3	-21	8	14	21	26	36	44	59	71	82	91	100	115
4	-16	6	11	15	19	26	32	41	50	57	63	68	78
5	-13	5	8	12	15	20	25	32	38	43	48	52	58
6	-11	4	7	10	12	16	20	26	31	35	38	41	47
7	-9	3	6	8	10	14	17	22	26	29	32	35	39
8	-8	3	5	7	9	12	15	19	22	25	28	30	33
9	-7	3	5	6	8	11	13	17	20	22	24	26	29
10	-7	2	4	6	7	10	12	15	17	20	21	23	26

Source: Collier Capital, 2007.

Should a thorough due diligence be done, spending more than 40 hours per due diligence, then the overall multiple will increase to 5.9 times in a 4.1 year period, with an IRR of 57%. The execution of a thorough due diligence is a critical factor in reducing the risk of the investment. Figure 4.20 shows the effect of a thorough due diligence. (Wiltbank and Boeker, 2007: 5)

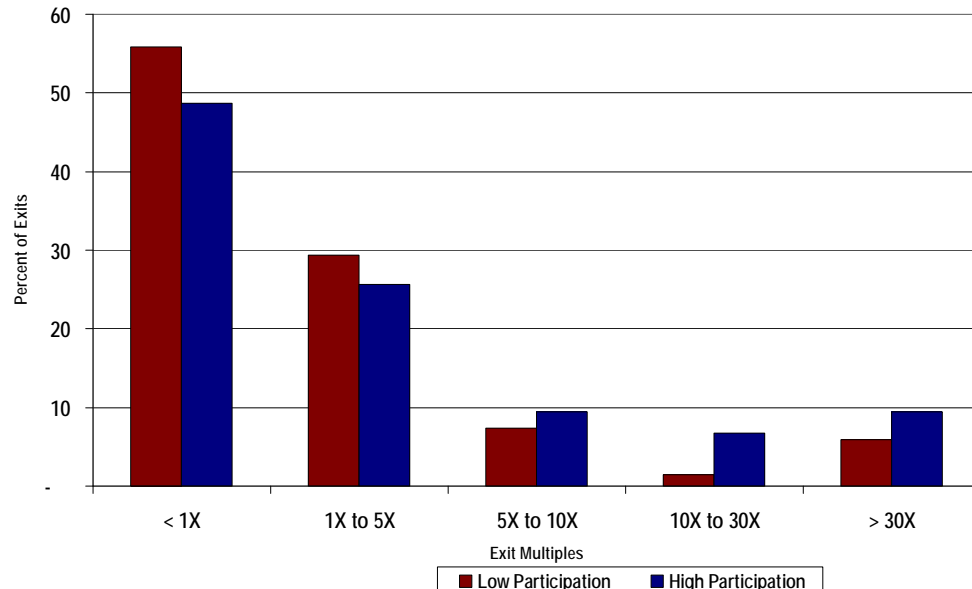
Figure 4.20 The Impact of Time in Due Diligence.



Source: Wiltbank and Boeker, 2007: 5.

The investor's participation through mentoring, coaching, financial monitoring and making connections after making the investment is significantly related to the venture's outcome. The involvement measured is at a high at once to twice a month and on a low at once or twice a year, and the impact of the high and low participation is shown in figure 4.21 below. The impact of participation is not only restricted to angel investing, but follows through to later stage investment as well. Sharing the investor's skills and knowledge with the venture and its management team will increase their average return from 1.3 times in a 3.6 year period, an IRR of 6%, to 3.7 times in a 4 year period, an IRR of about 41%. (Wiltbank and Boeker, 2007: 7)

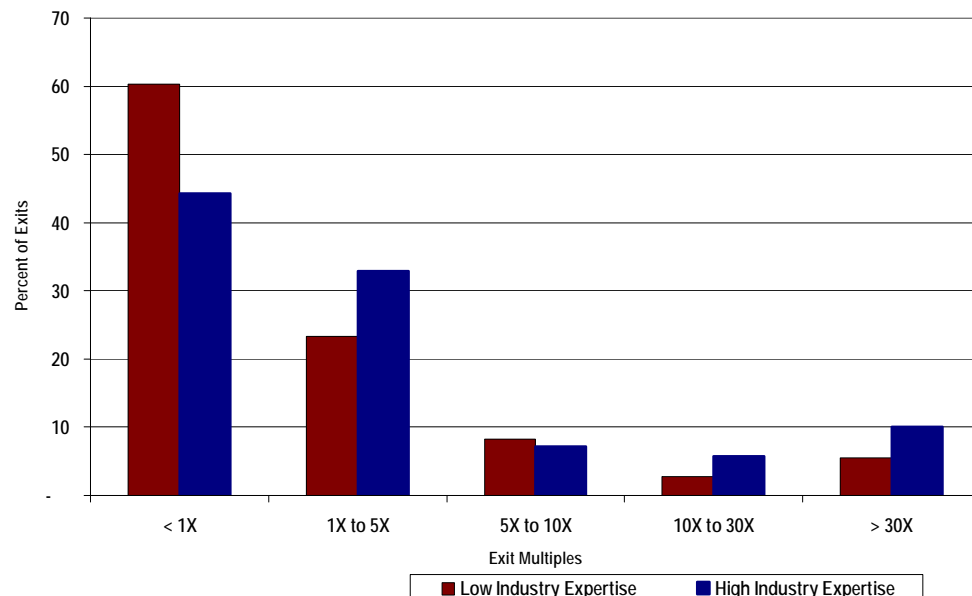
Figure 4.21 The Impact of Participation (mentoring, board and financial monitoring).



Source: Wiltbank and Boeker, 2007: 7.

The angel investor and for any other investor who wishes to ensure the success of his investment will invest within the areas of industry of his or members of his group's expertise. Focusing on a single industry or on a particular product will simplify their due diligence and also ensure that the investor would have the necessary knowledge to share. The investor would have the ability to execute a more insightful evaluation of the factors critical to the success of a new venture. Figure 4.22 shows the impact on the exit multiples should an investor invest in the industry he knows. The expected exit multiples will increase from 1.3 times, an IRR of 8%, if the investor has a low knowledge of the industry to 3.7 times in a 4 year period, an IRR of about 41%, when the investor has a high degree of knowledge of the industry.

Figure 4.22 Relationship to Industry Expertise.



Source: Wiltbank and Boeker, 2007: 6.

4.5 Recent Trends and Developments in the United States of America.

Sohl and Rosenberg, 2003, researched the trends in the USA angel and venture capital markets after and before the 2000 investment bubble-burst. Their research started in the 10 years prior to the burst and followed on thereafter. Their findings are critical in the evaluation of any angel and venture capital investment today, and the planning ahead.

The venture capital markets, with the emerging hard drive market, became very hot with a growth from \$49 million in 1976 to \$4.6 billion in 1986. In the same period the angel investment market was estimated at \$10 billion with close to 30 000 start-ups at the peak. The buoyant stock markets attracted even more investments and more venture capitalists and angel investors entered the market. The majority of angel investors and venture capitalists entering the market had little to no experience in either the industry or the investment market and could not add any value to their investments through the transfer of knowledge and skills. The angel investors and the venture capitalist had large amounts of money at their disposal that they had to put to work. The oversupply of available

investment funds drove up valuations and subsequent deal prices to unrealistic levels. The high risk of the overvaluation and the increased size of investments encouraged the venture capital industry to seek safety in later stage and larger deals. The due diligence process that should have been done was downscaled with one aim and that was to get the funds invested. Angel investors provided the start-up capital needed by the new ventures and fulfilled the need in the market. Traditionally, however, angel investors were operating quietly as a relatively unknown entity until the seminal paper published in 1983 by William Wentzel, who recognised their unique contributions to the financing of high growth entrepreneurial ventures. (Sohl and Rosenberg, 2003: 7 – 8)

All the factors mentioned above led to the overheating of the market to the extent that ever increasing amounts of funds were needed to fund the needs of the ventures, whilst the returns on these investments decreased rapidly. Venture capital firms started to use their available funds to bridge portfolio companies' need for extra funding rather than adding new firms to their portfolio. The unsustainable trends of high returns eventually returned to normality in 2000 and 2001, but not before there were devastating effects in the market. In California, Silicon Valley experienced 4000 job losses per month. The local unemployment rate jumped from 1.3% to 6.6% in a year. (Sohl and Rosenberg, 2003: 10 - 11). Many lessons were learned from the above experience during this period, and will be dealt with in section 4.5.1

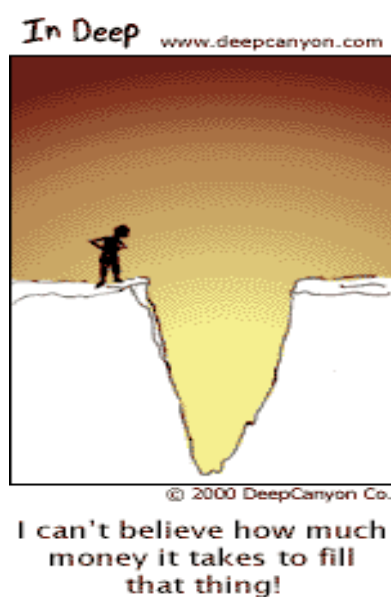
4.5.1 Lessons from the 2000 Market Collapse.

The most important lessons learned, as researched by Sohl and Rosenberg (2003:16 - 18), regarding the 2000 market collapse are as follows:

- The new VC funds started and the need for new fund managers added to a layer of inexperience in a market filled with uncertainty.
- The new participants had no experience of downturns and did not realise that this could happen.

- Many of the new entrants had garnered their wealth from public equity deal making, rather than cutting their teeth in the private equity markets or the more traditional angel route of cashed-out entrepreneurs. Public sector experience does not fare well in the vagaries of the private equity market for the following reasons:
 - Illiquidity – funding gap; the venture always needs more money than anticipated. Please see figure 4.23.
 - Lack of financial data. A financial history, street wise knowledge, on which to base forecasts and the absence of audited financial data was a problem.

Figure 4.23 The Funding Gap.



Source: Sohl and Rosenberg, 2003: 11.

- As more and more money flowed into venture capital funds, \$100m deals became the norm. The following mistakes were consequently made:
 - The large investment funds lacked the “strike force” mentality to concentrate on the industry sector they knew best.

- There was pressure to invest funds in sectors of which the investors had little or no experience.
 - With the larger funds and the increase in the number of deals, the value added dimension became less prominent. Venture capitalists were stretched thinly across several portfolio companies.
- As companies rushed to second rounds of private equity financing, the value added start-up business experience of angel investors became discounted. Research indicated that business experience provided by angels is considered by the majority of entrepreneurs just as important as the capital provided by the angels. The angel's value added was diminished through the rapid influx of new investors, at precisely the time that the entrepreneur and the new management team needed this valuable advice.
- Along with the shorter time scale between external equity rounds, the entire line from start-up to exit was abbreviated. The patience associated with the angel investment process disappeared. Companies were built up by the entrepreneurs, VC and angel investors for an exit, rather than continuing to build a solid company. Lacking a clear business model and a path to profitability, many of the brightest and well-educated MBAs brought into the venture as the management team, lacked the foresight to recognise the inherent flaws in the underlying business model.
- The inherent high failure rate in high growth ventures was overlooked by many novice and experienced investors. The rule to only invest what one can afford to lose was replaced by the dreams of capital gain multiples never witnessed before.

- Venture capital firms are interested in high returns and left the development of innovation behind. Innovation is the core of venture capitalism and this was ignored for chasing the dream of high returns. (Sohl and Rosenberg, 2003: 8 to 13) and (Stuck and Weingarten, 2004: 1 to 3)

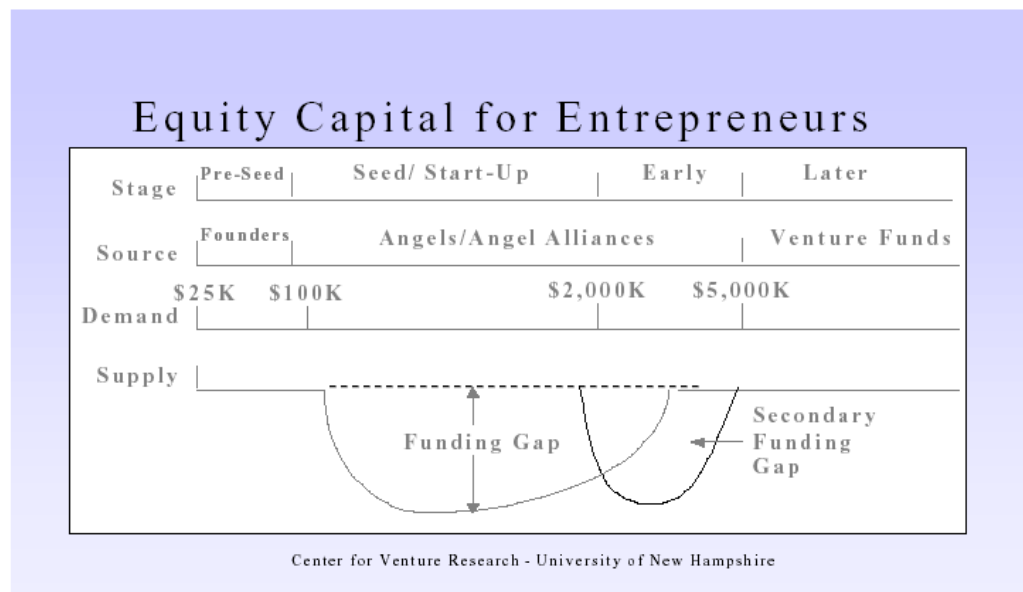
- The Funding Gap.

The financial theory is predicated on the assumption of efficient capital markets with fully informed buyers and sellers and low transaction costs. The markets are not perfect and these market imperfections, prevalent in the informal venture capital market, lead to two types of market inefficiencies, collectively referred to as the funding gap.

- Capital Gap. – This exists between the needs of early stage ventures and the suppliers of early stage capital. High growth ventures need patient, value added equity capital to fuel growth. In efficient markets the ventures receive all the capital needed and there are always funds available. This is not true of the real markets. The high tech market is littered with promising entrepreneurial ventures that do not receive the critical capital needed to move promising technology from the laboratory to the market place.
- Information Gap – An efficient market implies an open and timely flow of reliable information concerning financing sources and investment opportunities. In the formal venture capital market, with the suppliers of capital seeking a degree of anonymity, there is often some conflict with the need to maintain quality deal flows, whilst information flows very inefficiently.

The capital and information inefficiency results in two substantial funding gaps in the private equity market (see figure 4.24). The first gap occurs primarily in the seed and start-up financing stage and is a result of both capital and information inefficiencies. Sohl and Rosenberg, (2003: 8 to 13) indicates that angel investors provide close to 80% of the seed and start-up capital for high tech entrepreneurial ventures in the USA. The role of angels is critical and proof is found in the lack of attention afforded to this seed and start-up stages by the venture capital industry. The second market gap occurs in the early stage of equity financing. As the venture capital industry progressed to larger and later stage financing, and the informal market remained active below US\$2m, a capital gap in the US\$2m to US\$5m range had developed. Venture capital funds wish to invest large amounts, while angel investors concentrate on smaller amounts. Consequently nobody services the needs between the above two.

Figure 4.24 Funding Gap and Secondary Funding Gap.



Source: Sohl and Rosenberg, 2003:14.

Entrepreneur's search for capital and funding is time-consuming which indicate that many opportunities are missed by the entrepreneur. The capital and information gap could well cause the failure of ventures because of a lack of sufficient funding. (Sohl and Rosenberg, 2003:16 to 18)

4.6 **Conclusion.**

The success of venture capital investment, including angel investment, depends on many factors. The investment market changed over the years as indicated in figures 2.1 to 2.3 with a further change when private equity investing came about. Venture capital investors now prefer larger and later stage investments, whilst the angel investors supply the funding for the smaller and early stage investments. The angel investors are normally wealthy individuals who used to be involved in entrepreneurial companies and now want to invest not only their own money, but also their knowledge and skills in newly formed companies. Venture capital investors are normally wary of becoming involved with newly formed companies and prefer later stage companies because they are typically fund managers with little or no experience as entrepreneurs. The role of angel investors is only officially recognised in the USA. The lack of recognition of angel investors in the United Kingdom and South Africa creates an investment gap in the market leading to an increasingly high risk of venture investment.

Private equity companies, including venture capital funded companies, are responsible for higher economic growth in the relevant countries described earlier, compared to other companies in the economy. Over a period of five years up to 2006 the annual sales in private equity companies rose by 9% compared with 7% of the FTSE100 and 5% of the FTSE Mid-250 companies. The venture capital backed companies in the USA employed over 10.4 million American workers and generated US\$2.3 trillion in revenue in 2006. The total revenue of venture financed companies comprised 17.6% of the national GDP and 9.1% of the USA's private employment in 2006. Employment grew by an average of

5.4% in these companies in Europe while the average employment growth in the European Union was 0.7% over a period between 2000 and 2004.

The transfer of skills and knowledge is important to the investees and they rate marketing, management recruitment, help with contracts, financial advice and strategic direction as the most important contributing terrains. The findings are supported by research and are displayed in tables 2.2, 2.4 and figure 4.3. The knowledge and skills of the investors vary from the type of investor involved. Angel investors normally dispose of a sizeable amount of practical knowledge, whilst the typical venture capitalist is in almost all the events a fund manager with virtually no experience and knowledge of practically managing and developing a business. The venture success rate can vary between 90%, where knowledgeable angel investors and venture capitalists are involved, to as low as 20% in the absence of the above knowledge and skills and the presence of vulture capitalists. Many factors contribute to an increased success rate of an investment of which the most telling factors are a proper due diligence, the funding gap and investing in the industry known to the investor. Knowledge and skills of the industry help the investor to give the investee a competitive edge over other role players in the same industry and to ensure that the new venture would have sufficient funds available to fund the venture. Figures 4.20 to 4.22 are graphical presentations of all the factors contributing to the success of a venture and the risks involved in the absence thereof.

The lessons learned during the 2000/2001 market burst, with the contributing factors to the burst, provide a clear indication that angel investors are a critical part in the investment process where knowledge and skills are transferred to the new venture. The involvement of the investor with the investee, proper due diligences, industry related investment, knowledge of the investment market and funding of the funding gap are important lessons learned during this process. The lessons learned were put to use and most venture investments are now done in the following manner:

- (1) Realistic projections and deal prices are thoroughly analysed.
- (2) Angel investors' core values are now implemented.

- (3) Angel investors began to assert their role as value added patient investors in entrepreneurial ventures.
 - (4) Angel investors continue to invest close to home in order to be close enough to render an input.
 - (5) Both entrepreneurs and investors are striving to build companies with real value and sustainable growth.
 - (6) Investors concentrate on an excellent management team and not such excellent ideas, rather than the reverse.
 - (7) Investments are used to develop high risk technologies with a reasonable chance of success.
 - (8) Cash flow is now the key to success.
 - (9) The role of government in the private equity market is now as important as ever.
- (Sohl and Rosenberg, 2003:18)

The survey of recent international research as discussed in chapter 4, specifically done in the USA and Europe, is shown in the table below. The results address some of the question of the South African survey which is indicated likewise. The question number of the South African survey to which the results refer to is indicated on the left hand side of the table below.

Tabel 4.6 USA and Europe Survey Results.

Questions	Description	Paragraph Addressed	Result
5	Market segments.	Par 4.3.2, Figure 4.15 and 4.16	The most popular sectors to invest in are computer software, semiconductors and electronics, healthcare and communication.

6	Investment stages.	Par 4.3.2, Figure 4.8 - 4.11	The majority of investments are made in the later stages of development of an enterprise. The earlier stages of development pose a higher risk and are avoided. The lack of knowledge and skills from the investor and the quantity of funds to invest create this situation. Contrary to the above, Angel investor prefer to invest in the earlier stages.
9	Number of investments made.	Par 4.3.2, Figure 4.12	The majority of funds made between 3 -5 investments per year.
11	Source of funds.	Par 4.3.1, Figure 4.4 - 4.6	Majority of the investments originate from government agencies, banks, pension funds, insurance companies and fund of funds.
13	Success rate of investments.	Par 4.3.2, Figure 4.17 - 4.20	Angel investors experience a much higher return on investment in the first ten year than private equity and venture capital investments. Private equity on their turn experiences a much higher return in later stage investments. The success rate increases if a proper due diligence is done. The creation of jobs increased in Europe and the USA due to venture capital investment.
18 – 21	Investor's involvement in investee.	Par 4.3.2, Figure 4.11 and 4.21	Small percentage investors are involved in the matters of the portfolio company. Active involvement by the investors has a positive effect on the success of the investment. Private equity investors prefer not to involve in the earlier stages of investment whilst the angel investors prefer to be involved in those earlier stages. Low involvement by the investor increases the risk of failure by the investee.
24	Investment in known industries.	Par 4.3.2 and 4.4	Investing in industries known to the investor increases the success rate of the portfolio companies.
30	Value adding activities.	Par 4.2.3, Figure 4.3.	The most important value adding activities from the investor to the portfolio company are found to be strategic directions, financial advice, contracts, management recruitment and marketing.
31	External director's involvement.	Par 4.3.2, Figure 4.21	The participation of external directors does have a positive effect over the long run, on the internal rate of return of the portfolio company.

32	Excellent idea versus complete management team.	Par 4.5.	An investor will rather invest in a complete management team and not such a excellent idea than in an excellent idea and an incomplete management team. The risk that an incomplete management team poses for the investor is just to high. This is mainly true for private equity investors where their involvement in the portfolio companies is restricted.
45	Investing to maximise return.	Par 4.4.1	Investor normally expects the highest possible return on the investments made. This policy has a negative effect in that development can be ignored due to its low return with the consequential effects thereof.

Own composition.

The detail discussion of the results combined with the survey results done in South Africa will be discussed in chapter 6.

CHAPTER 5 RESEARCH DESIGN

5.1 Introduction.

This chapter briefly sets out the design of the research. A South African survey of companies in the venture capital and private equity environment is included in the survey done.

5.2 Research Population.

The research population consists of all the companies that are actively involved in private equity, venture capital and angel investing in South Africa and that are registered members of the Southern African Venture Capital and Private Equity Association.

5.3 Research Sample.

The survey was based on the complete population of the venture capital firms registered as members with the Southern African Venture Capital and Private Equity Association (SAVCA) as found in the “Private Equity and Venture Capital in SA – 2007 industry review”, compiled by SAVCA (Lünsche, 2007: 42 -121).

5.4 Data Collection.

The data is collected from a survey questionnaire sent to the research sample as described in section 5.3 above. An electronic questionnaire was sent electronically via e-mail to the identified respondents, followed up with another e-mail 14 days after the first e-mail, where after the respondents were telephonically asked to complete the questionnaire. The questionnaire was completed telephonically in three instances.

5.5 Data Interpretation.

The data collected in the survey were compiled in different sub-sectors and interpreted and collusions were made. The interpretation of the information gathered was measured against the objectives of the study.

5.6 The Survey.

The descriptive survey method is used to gather the information needed. The aim of the survey is to determine the importance of the following factors in the transfer of knowledge and skills in the investments process, as well as the effect on the success of the venture in the South African market. The factors included in the questionnaire are;

- ownership,
- executive, non executive and external directors,
- board of directors,
- CEO,
- management team,
- entrepreneur,
- mentor and mediator,
- physiological and brain preference tests, and
- knowledge management.

5.6.1 The Survey Questionnaire.

- **The Composition of the Survey Questionnaire.**

The survey questionnaire is composed of all the factors excluding production, marketing and product development that exert an effect on the success of a venture as listed in figure 7.1. The mentioned factors have an indirect or in some instance

a direct influence on the success of venture capital investment. The questions in the questionnaire cover the mentioned important factors and are use to obtain an indication from the respondents of their importance in the venture capital process. The detail of the composition and operation of the questionnaire will be dealt with later in this chapter. The questionnaire (Annexure A) includes:

- The geographic information about the respondent in order to identify the respondent, his/her age and whether the respondent would wish to receive any feedback. It was also determined whether the respondent is a private equity investor, venture capitalist, angel investor or an entrepreneur.
- An investor's part with questions regarding the factors mentioned in section 5.6 above. The questions cover the venture capital process in line with literature survey and the objectives of the study.

- **Electronic Questionnaire and Database.**

The questionnaire was made available electronically to the respondents. The respondents were required to complete the questionnaire online via the Internet. On completion and submission of the questionnaire the information was stored electronically in a Microsoft Access Database.

An e-mail letter (Annexure B) was sent out to all respondents. The letter contained a link to the questionnaire. Submission of the questionnaire was only possible if all questions were answered. E-mail addresses were recorded and used to ensure that respondents did not submit a response more than once.

- **Pre-Testing of the Survey Questionnaire.**

The questionnaire was pre-tested and adjusted before it was used in the main survey. The respondents were asked to comment on:

- The length of the questionnaires,
- The layout of the questionnaires,
- Whether the questions are clear and unambiguous and addresses the important issues,
- Whether the process to submit is easy enough.

5.7 **Summary.**

The results of the South African electronic survey questionnaire, sent to all the members of the Southern African Venture Capital and Private Equity Association (SAVCA) as described in this chapter, is discussed in the next chapter.

CHAPTER 6 DATA ANALYSIS AND INTERPRETATION

6.1 Introduction.

New business development is critical for the growth and development of any economy in the world including the South African economy. The involvement of the angel investors, venture capitalists and private equity investors determines the success of the investment in new business development. The survey was sent to all the registered members of the Southern African Venture Capital and Private Equity association in order to get the best representation of the South African new business investment. Economical growth and job creation is dependant on the development of new ventures that imply higher risk. The survey concentrated on aspects that determines and influence the success of the venture which will consequently reduce the risk of the investment.

6.2 Results of the Survey.

The South African survey was sent electronically to 54 registered members of SAVCA of which three indicated that they are neither a private equity nor a venture capital company. One of the companies is in liquidation and is excluded from the survey. Out of the 50 potential respondents, 31, which represents 62%, completed and submitted the questionnaire successfully. In terms of rand value, this represents quantitatively more than 60% of the value of the specific investments made in South Africa. One of the respondents, Business Partners, contributed 69% of the total number of investments made in 2007 (Watkins and Fourie, 2008: 27). The South African private equity and venture capital investors concentrate mainly on later stage investments whilst the seed and start-up companies are only addressed by a few investors as will be indicated later in this chapter.

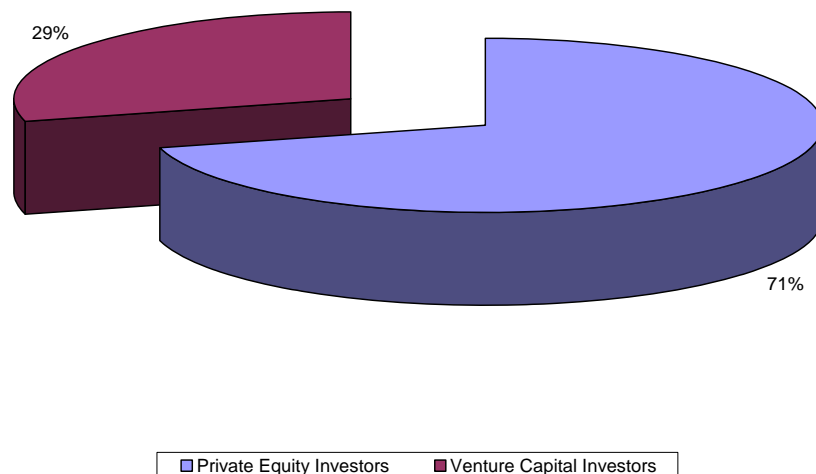
6.3 Data Analysis.

The data gathered is analysed and the results are presented in graphs that are compared and interpreted in the paragraphs that follow.

6.3.1 Respondents/ Investors.

The respondents to the questionnaire are divided into venture capital and private equity investors. The distinction between the two categories are made mainly because it is expected that the venture capitalist will concentrate on earlier and later stage ventures whilst the private equity investors will concentrate on later stage ventures. The areas that the private equity investors normally concentrate on are management buy-outs, mergers and acquisitions and leverage buy-outs. The division is shown in figure 6.1 below.

Figure 6.1 Responses: Private Equity as Opposed to Venture Capital Investments.



Of the respondents, 71% is private equity investors as opposed to 29% which is venture capitalists. Value that can be added by the investor through the transfer of knowledge and skills to the venture and its management team depends on the investors own knowledge and skills gathered in the involvement in previous ventures. Many venture capitalists and private equity investors have previous entrepreneurial experience as can be seen in figure 6.2 and 6.3. About 48% of the investors have no previous entrepreneurial experience. The possible transfer of knowledge and skills becomes restricted in these cases. Entrepreneurial experience is gathered through practical experience where valuable knowledge and skills are added to the skills pool of the investor. The years of experience indicated in figure 6.3 are mainly investment experience that can not be seen as “streetwise” entrepreneurial value adding experience that can add value to the venture and its management team.

Figure 6.2 Previous Entrepreneurial Experiences of Investor.

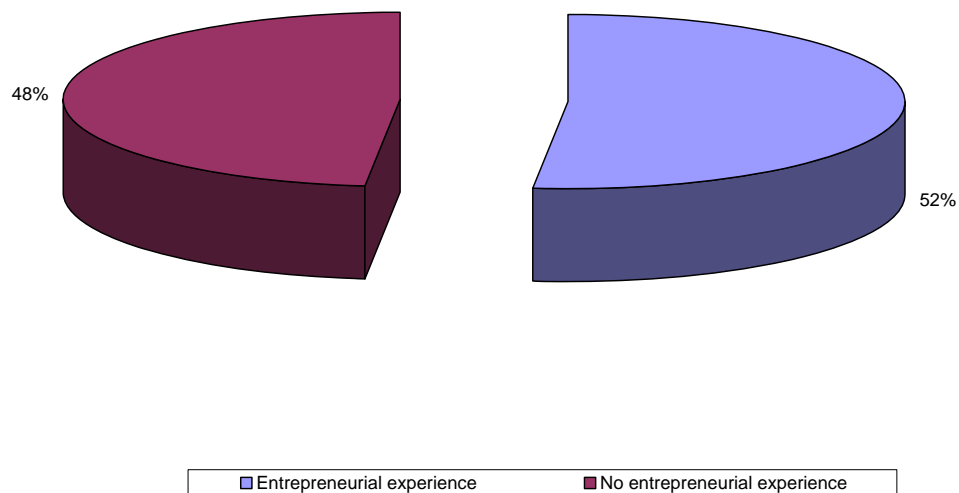
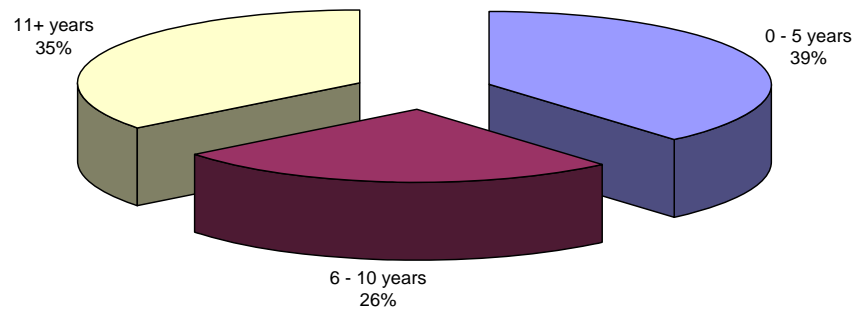
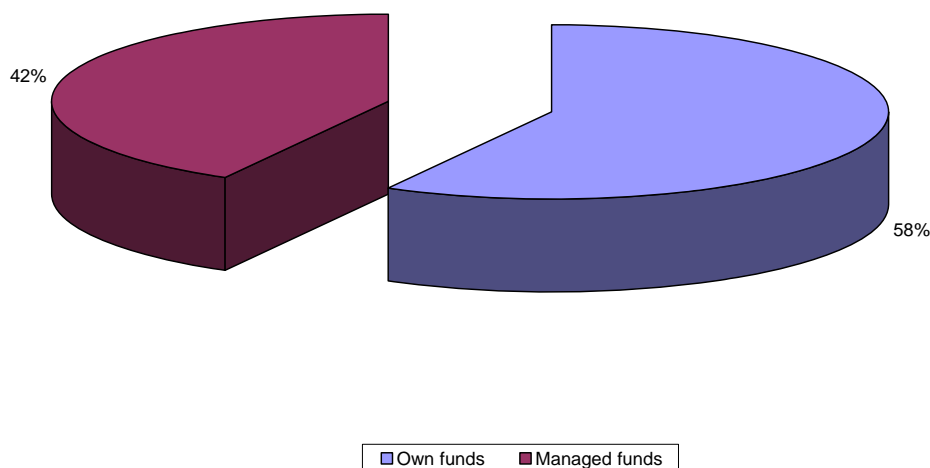


Figure 6.3 Investor's Experience in Years of Involvement.



A further success determining factor in the commitment of an investor to a venture is when the investor is prepared to invest his own funds in a venture. About 42% of the investors can be seen as fund managers and do not invest their own funds while 58% invest some of their own funds in the ventures they invest in, see figure 6.4.

Figure 6.4 Investment of Own Funds.

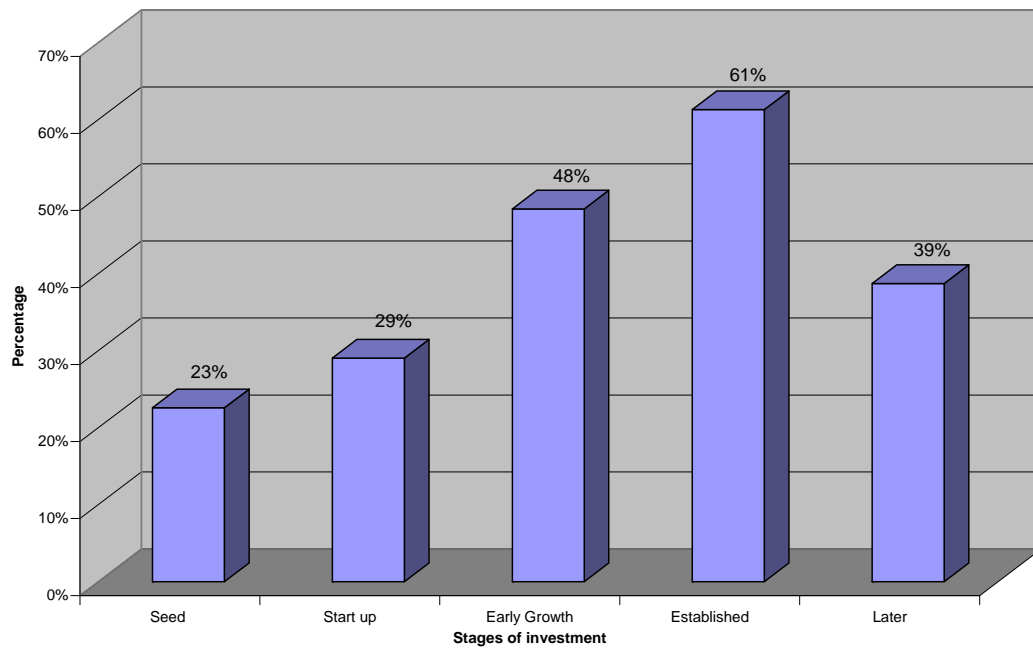


The investor must be a campaigned entrepreneur and investor with experience, tacit knowledge and commitment, to contribute maximal value to the newly found or established venture. At least half the investors have previous experience as an entrepreneur, more than 60% as investor for a period longer than five years of which 58% are prepared to invest their own funds in the venture in question.

6.3.2 Distribution of Funds over Different Investment Stages.

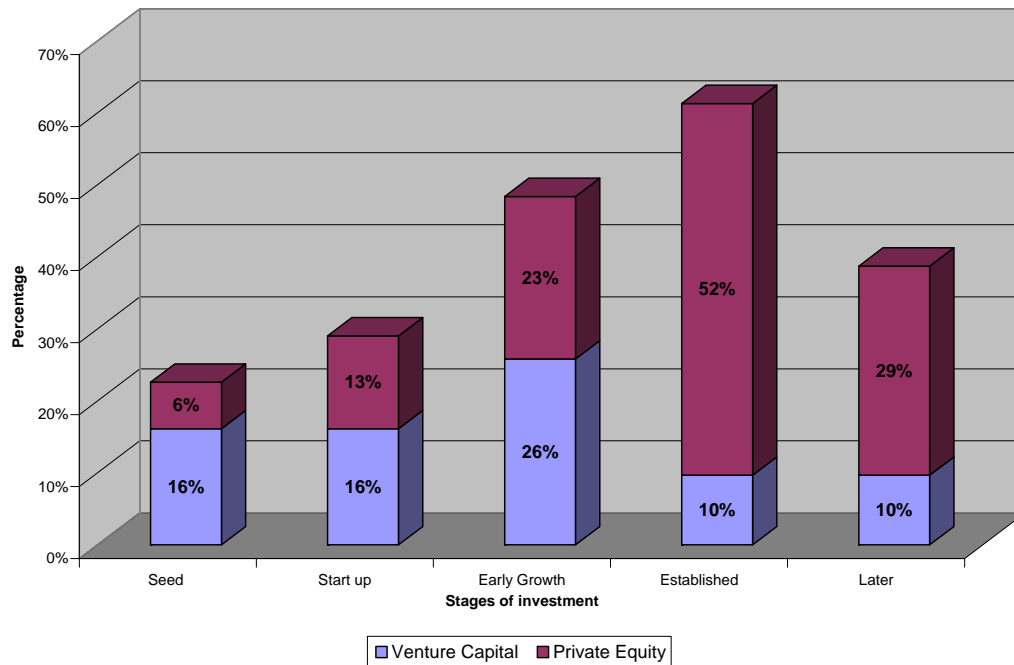
The investor's involvement in the different investment stages namely seed, start-up, early growth, established and later stage are determined by the type of investor, that is, an angel, venture capitalist or private equity investor. The investor's choice of investment stage is determined by the perceived risk, complimented with the knowledge and skills of the investor, that the investor is prepared to take. The respondent's distribution can be seen in figure 6.5.

Figure 6.5 Distribution of Funds over Different Investment Stages.



The respondents who consists mainly of private equity investors and which make up 71% of the population as can be seen in figure 6.1, prefer to invest in later stage ventures. Figure 6.6 illustrates the distribution of funds between venture capitalists and private equity investors.

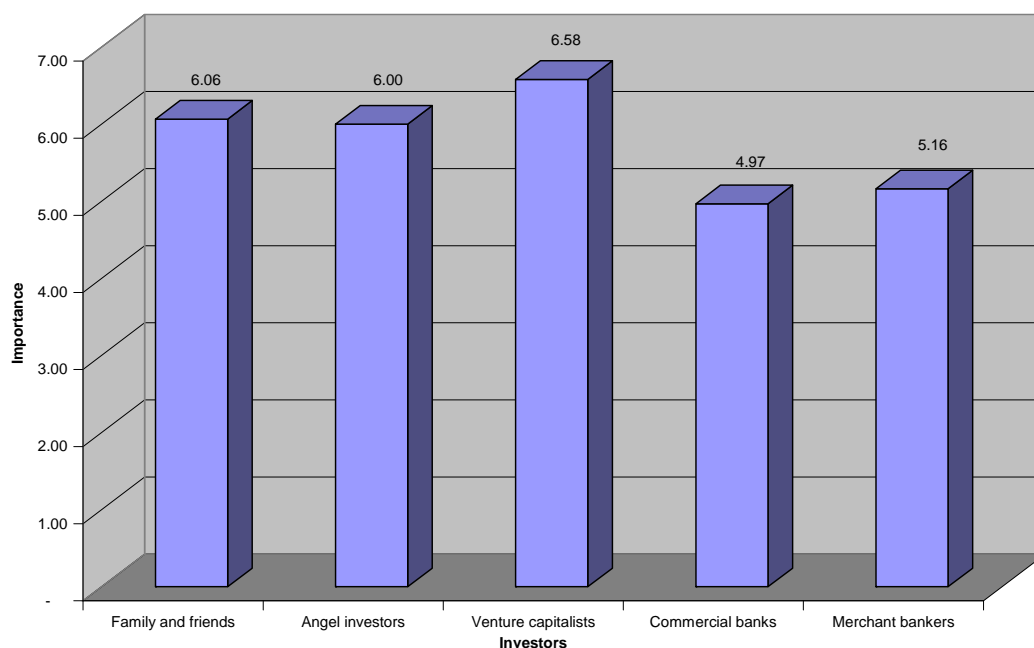
Figure 6.6 Distribution of Funds between Venture Capital and Private Equity Investors.



Venture capitalists prefer to invest in the early growth and later stages of a venture's development whilst private equity investors prefer established and later stage involvement. Angel investors tend to concentrate on the seed and early stages, the venture capitalist on the start-up to early growth stages and the private equity investors on the established to later stages of a ventures development. Each one of these investor groups has a specific role to play in the development of the venture and contributes to the success of the venture. The angel investors group is not formalised in South Africa and in Europe whilst they are well established in the USA. The absence of the angel investors as a formalised investment group gives rise to the slower development of new ventures in South Africa and in Europe. The development of new ventures depend totally on own funding and funding from family and friends that believe in the entrepreneur and his new venture. The importance of all the role players as indicated in figure 2.3 has been confirmed and is shown in figure 6.7. The perceived role that each investor group has to play is clear in figure 6.7 with the commercial banks that is seen to be less important in the development of a venture. The commercial banks are very reluctant to support seed

and early stage venture development and if it is supported the commercial banks cover their risk through security over tangible assets. The merchant banker's role is also limited to the involvement of leverage or management buy-outs and listing on the stock exchange. Venture capital investment is seen in South Africa as a very high risk investment that is only done by the brave.

Figure 6.7 The Importance of Different Investor Groups.



The providers of external finance to a venture as seen in figure 6.7 correlate with the findings in figure 3.1. Each investor group are prepared to take a different level of risk in a venture. Family and friends as well as angel investors are the investor groups that believe strongly in the entrepreneur, the jockey, and back the jockey whilst they form part of the venture's development in the founding stages.

6.3.3 Investor's Involvement in the Portfolio Company.

Investors are involved in the portfolio companies on different aspects in the company depending on their expertise and the role they accept to play. The main areas of involvement that have been included in the survey, are; investor/ shareholder, director of the company, non-executive director, external director, appointment of the CEO and members of the management team. The role that an investor plays is determined by the risk assessment made and the expertise of the investor. In figure 6.8 it is clear that not all the investors are actively involved as a shareholder in the ventures they invest in. The lack of involvement at the shareholder level indicates that some of the investors are only fund managers and operate in the same way as commercial banks where their involvement is purely as the provider of finance and not the development of their portfolio companies. Investors also prefer to be involved as non-executive directors as opposed to directors which allow the investor to have an active knowledge of the venture without being involved in the day to day activities of the venture. Venture capitalist investors and private equity investors have the same investment strategy as can be seen in figure 6.9. The differences between the venture capitalist and the private equity investor involvement are mainly at shareholder level, non-executive director and involvement as CEO of the company. The venture capitalists tend to be more involved as CEO of the venture as opposed to private equity investors, while the private equity investors tend to be more involved as investor/shareholder and non executive directors. The private equity investors tend to be more involved in the management team of the venture as the venture capitalists, which is a clear indication that the private equity investors invest in ventures together with a complete management team.

Figure 6.8 Stage of Investor's Involvement in a Venture.

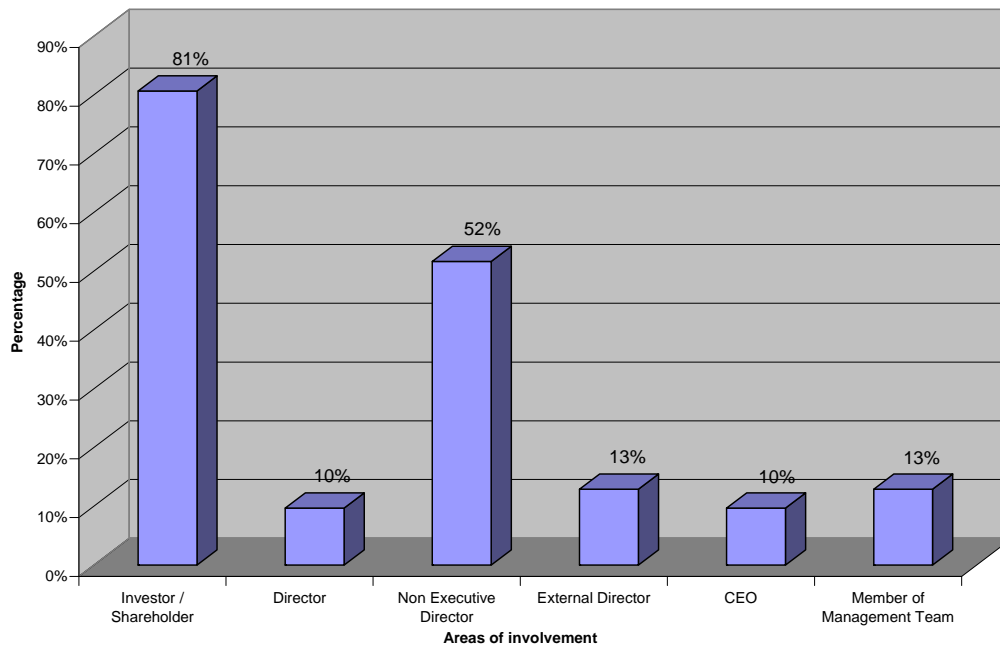
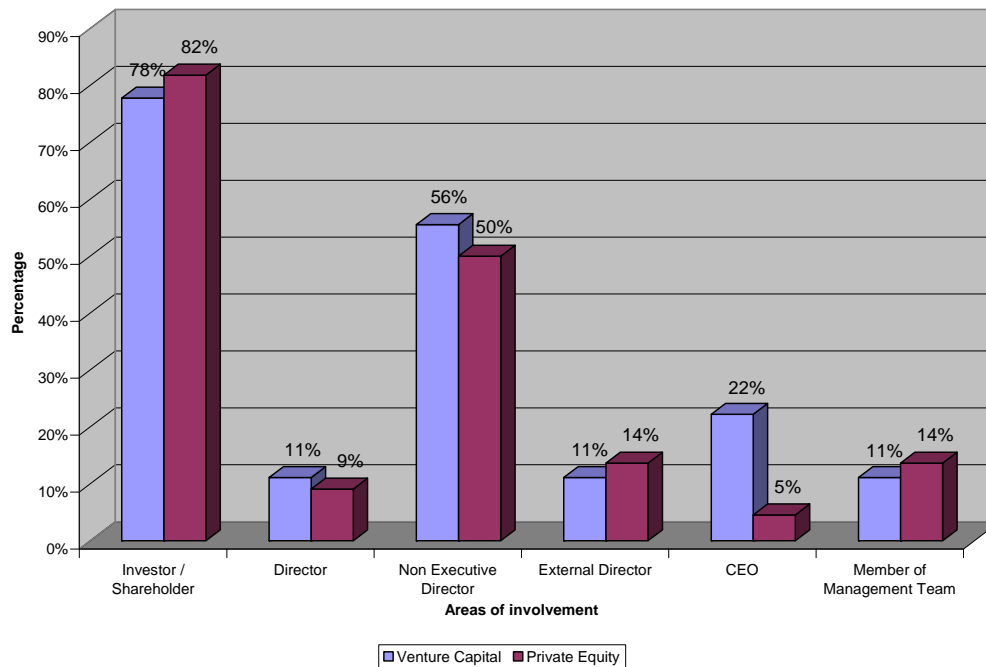
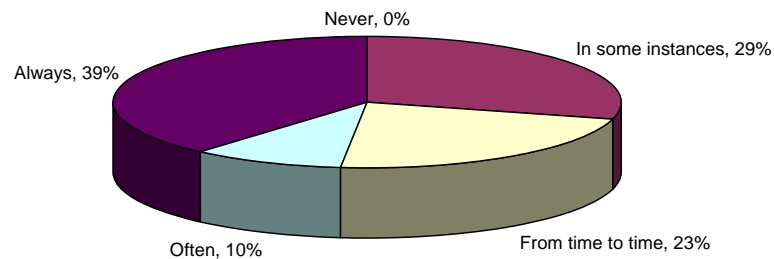


Figure 6.9 Venture Capital versus Private Equity Investor Involvement.



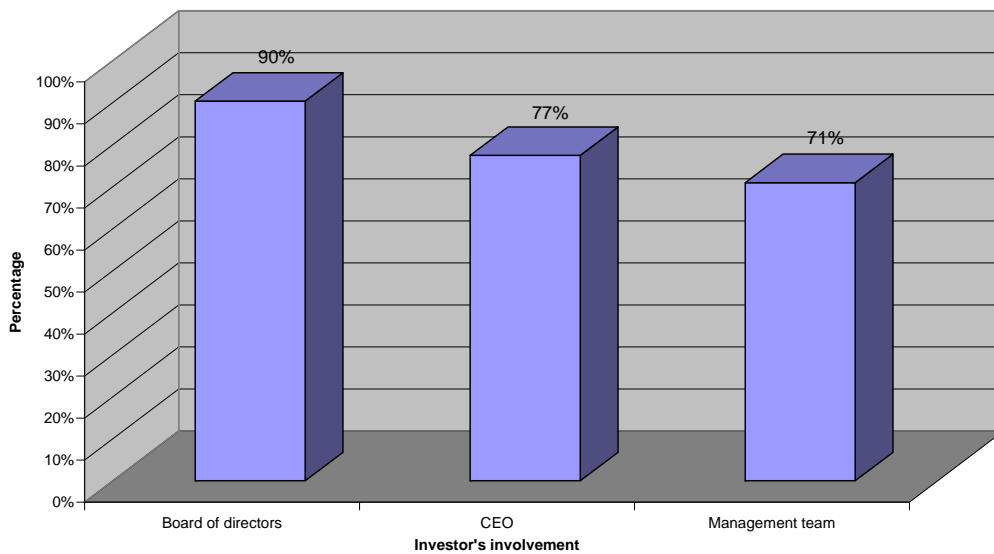
The investor's appointment as a non-executive director exists in 52% of all investments made as can be seen in figure 6.8, whilst 39% of the investors always appoint a non-executive director to represent them, as can be seen in figure 6.10. The non-executive director transfers knowledge and skills to the venture's management team and capacitate them. The findings correlate with the findings in figure 2.4.

Figure 6.10 Appointment of Non-Executive Directors.



The appointment of a non-executive director is always considered to a certain extent when an investor invests in a venture as can be seen in figure 6.10. Investors reduce their risk through their involvement in the selection of the board of directors, CEO and the management team as can be seen in figure 6.11. Ensuring that the management team (the jockey that must run the company) has the skills, knowledge, track record and the experience to run a venture effectively, reduce the investor's risk. Neither the venture capitalist nor the private equity investor will invest in a company with an incomplete management team. A later stage venture with an incomplete management team entails a high risk.

Figure 6.11 Investor's Involvement in Selections and Appointments of the Board of Directors, CEO and the Management team.



The investor's involvement differs from stage to stage of investment as can be seen in figures 6.12 to 6.15. Investors are quite actively involved in the day to day and monthly activities of a venture in the seed and start up phases. The investor's involvement regarding the operational and management level tend to shift from actively involved on a daily and monthly basis to quarterly, six monthly and annual involvements mainly on directors' level and shareholding meetings as can be seen in figure 6.12 to 6.15.

Figure 6.12 Investor's Involvement in the Seed Phase.

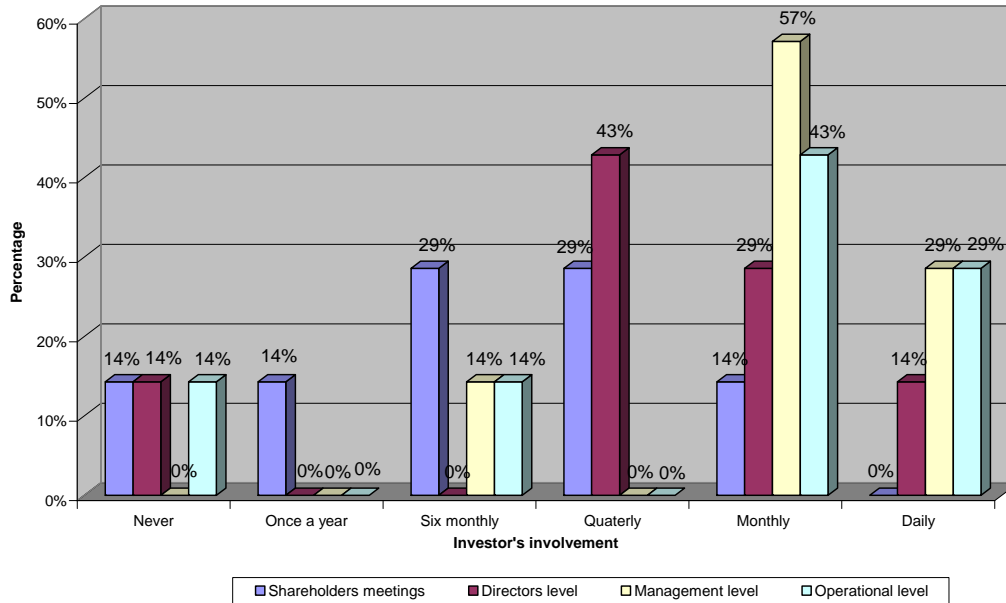


Figure 6.13 Investor's Involvement in the Start-Up Phase.

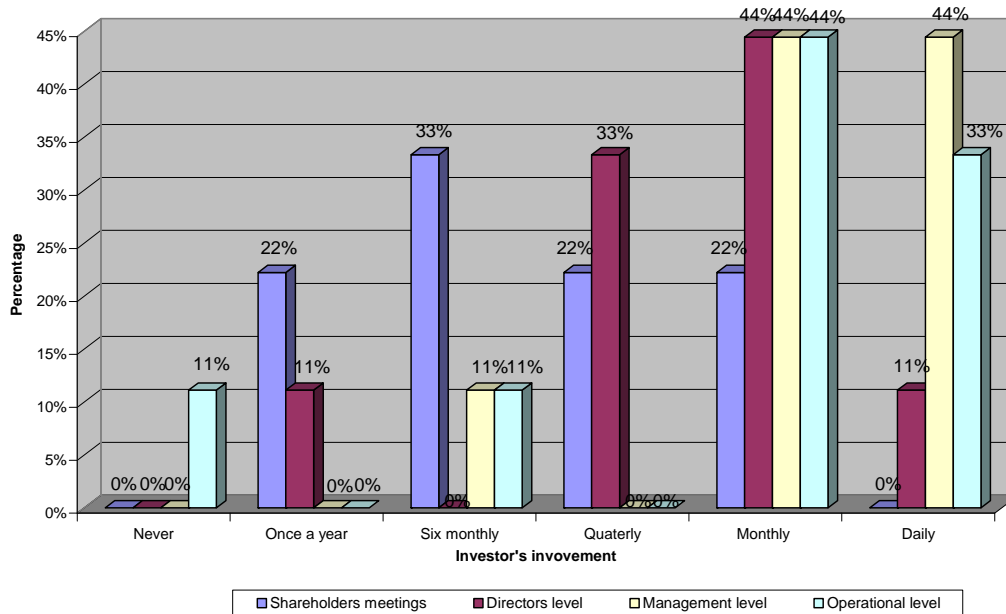


Figure 6.14 Investor's Involvement in the Early Growth Phase.

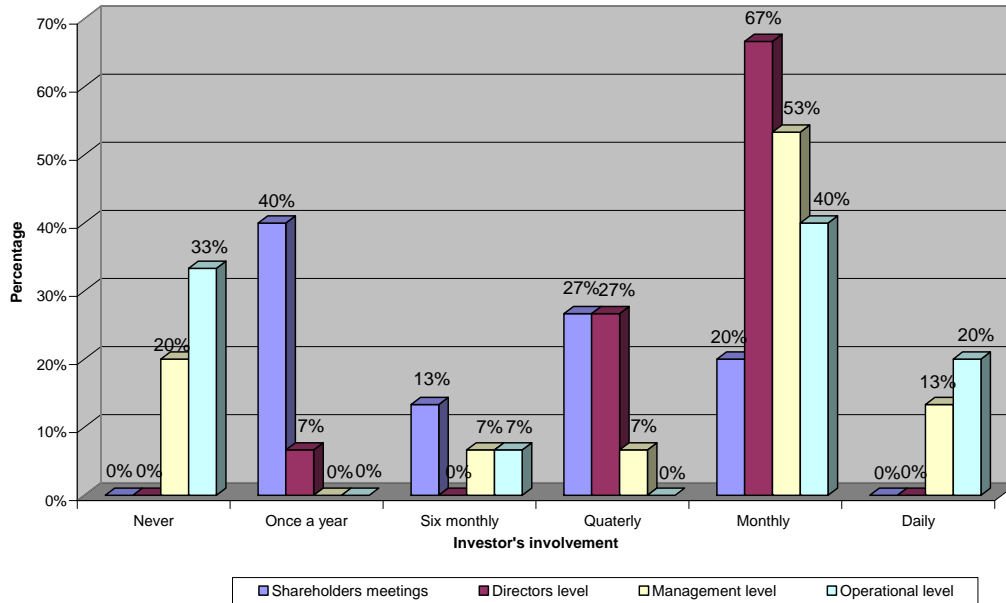
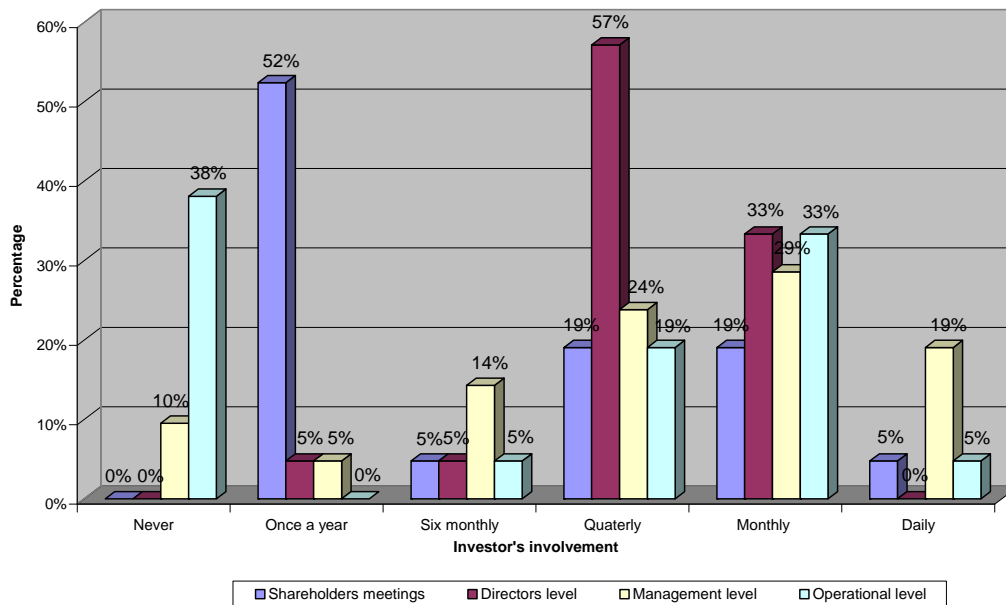
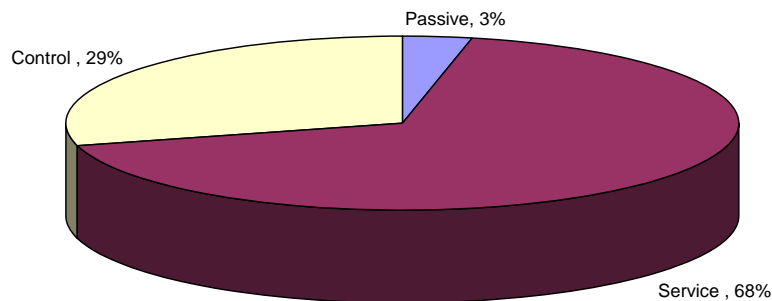


Figure 6.15 Investor's Involvement in the Later Stage Phase.



The role of the board of directors is seen by 68% of the respondents as a service role (see figure 6.16), where advice and expertise are provided to the management team. The investor become part of the venture and become the mentor of the venture's management team. In 29% of the instances, investors take control of the venture's management team on behalf of the investors, especially in larger ventures where an established management team exist and the control is needed to serve the best interest of the investors. Only 3% of the investors tend to be passively involved and allow the venture's management team to proceed as it did before the investment was made. The involvement of these investors is merely to fulfil the legal requirements with no input at board level directors and at the management level.

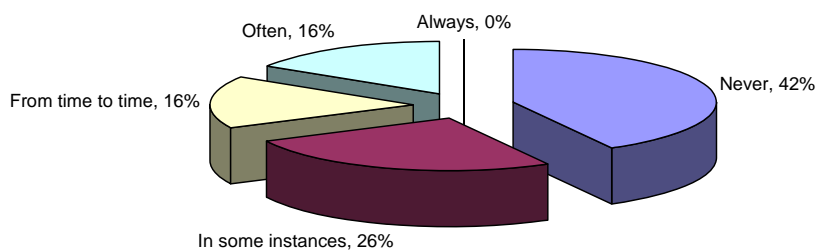
Figure 6.16 The Investor's Role in the Board of Directors.



6.3.4 Management Team.

The quality of the management team of a venture is a determining factor for investment in a venture as stated in paragraph 2.5.2. Investors prefer to invest in a venture with a complete management team although some investors will invest in a venture with an excellent idea and an incomplete management team as can be seen in figure 6.17. Fund managers will always prefer to invest in a venture with a complete management team while the venture capitalist and the angel investor are prepared to get involved in an incomplete management team. The findings correlate with the findings of the research in the USA and Europe, see paragraph 4.5, that the risk of an incomplete management team poses just too much risk for the later stage investor to accept. The angel investor's role is crucial in the development, management development included, of a venture to the level where it will be acceptable for the venture capital, private equity and later stage investors.

Figure 6.17 Investment in an Excellent Idea and an Incomplete Management Team.



A complete management team is not sufficient if the management team does not have the required characteristics. In figure 6.18 the most important characteristic that a management team must have is seen to be integrity, followed by motivation, intellectual honesty and leadership ability. The comparison of the importance of the different characteristics as researched by Hill and Power (2001: 118) and the results of this study can be seen in table 2.6 are shown in table 6.1.

Figure 6.18 Important Characteristics of a Management Team.

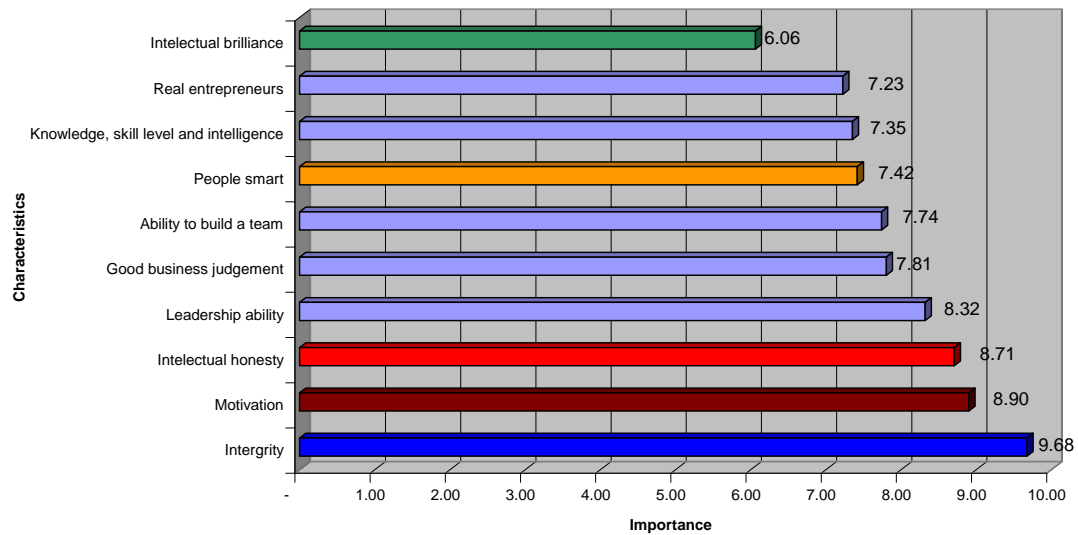
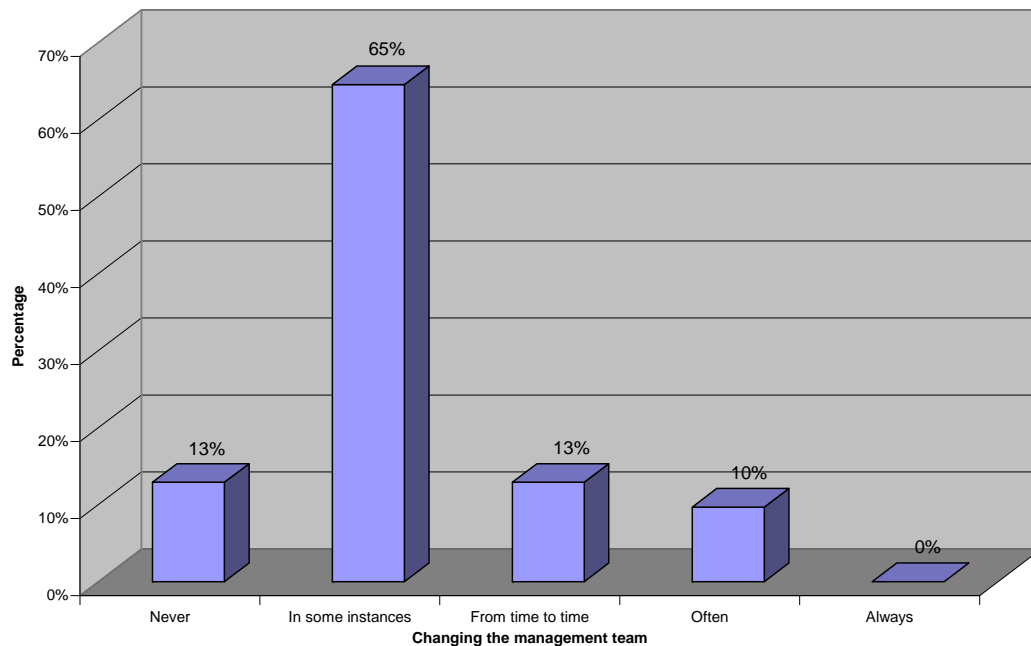


Table 6.1 Important Characteristics of a Management Team.

MANAGEMENT CHARACTERISTICS	IMPORTANCE (Hill and Power)	IMPORTANCE (this study)
Integrity	2	1
Dedication, commitment, passion and energy	3	2
Intellectual honesty	Not researched	3
Leadership ability	7	4
Vision and ability to articulate vision	4	5
Ability to build a team	7	6
People smart	Not researched	7
Knowledge, skill level, intelligence	5	8

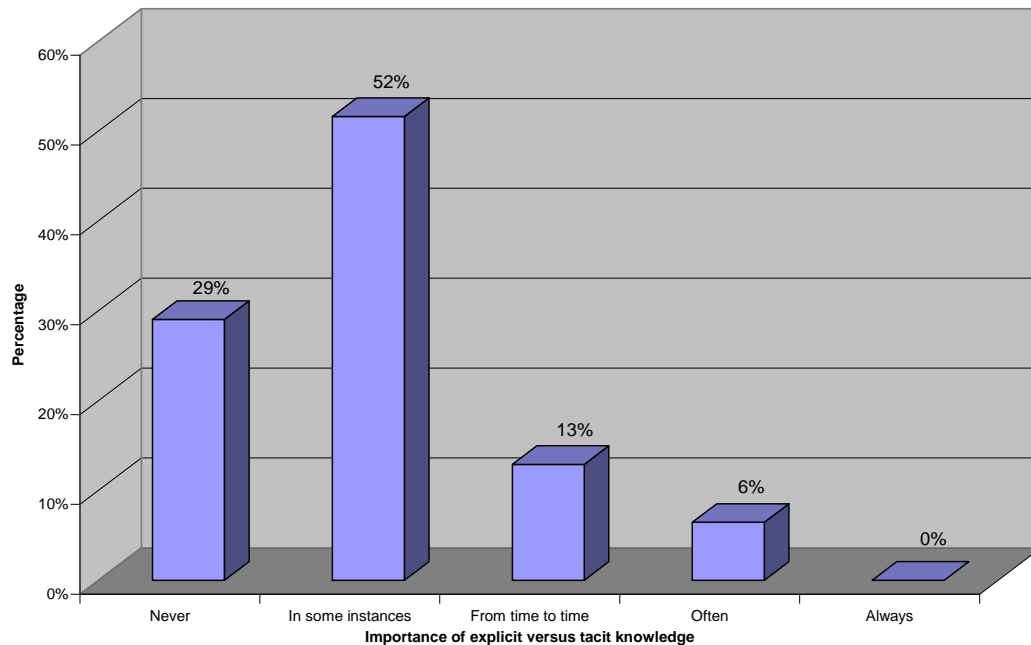
A clear correlation exists between the findings of Hill and Power (2001: 118) and this study as indicated in table 6.1. The importance of the knowledge and skills level deviate the most and is not seen to be that important in South Africa which is a clear indication that the investor is either directly involved in the venture or that the investors are fund managers, providers of needed funding, and not necessarily skilled and knowledgeable. The investors are usually directly involved in the selection of the management team although they rarely replace the management team as indicated in figure 6.19. Replacing the management team must only happen in the situation where the team is under-performing and introduces additional risk that may impact negatively on the success of the venture and the investment. Dismissing a team or team member does not necessarily increase performance. To the contrary, it might even have a negative effect on the performance of the venture, as stated in paragraph 2.5.3.

Figure 6.19 Change of the Management Team by the Investor.



In the selection of the management team, the investor and the other shareholders will have to consider the possibility of appointing a team member with more tacit knowledge than explicit (book) knowledge. Although the specific situation will dictate to the shareholders, it is found that in 29% of the cases the investors will never prefer somebody with explicit knowledge above somebody with tacit knowledge, and in 52% of the cases will only do the former in specific instances (see figure 6.20). It is clear in figure 6.20 that investors prefer someone that is “streetwise” and believe that such a team member will add much more value to the venture than a member with only explicit knowledge.

Figure 6.20 Appointment of a Management Team Member with Explicit as Opposed to Tacit Knowledge.



The success of the management team is determined by the characteristics mentioned in figure 6.18 but also in the ability to work as a team, cohesively achieving the stated goals. In figure 6.21, 97% of the respondents valued the ability to work cohesively as an important to extremely important ability of the management team. Cohesiveness can only be achieved if the personalities of the members of the management team are compatible. However, in figure 6.22 16% of the respondents did not deem compatibility to be important or of minor importance. Leadership and the ability of the CEO to manage the different personalities can be enhanced by the use of brain preference or psychometric test. The use of these tests is not common in South Africa as can be seen in figure 6.23. The results shown in figure 6.23 contradict the importance of working cohesively and the compatibility of personalities as seen in figure 6.21 and 6.22.

Figure 6.21 Importance of Working Cohesively.

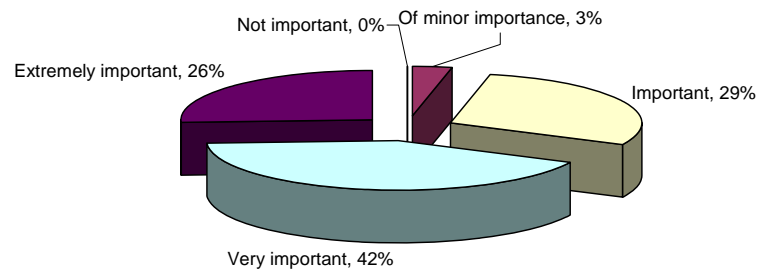


Figure 6.22 Importance of Personality Compatibility.

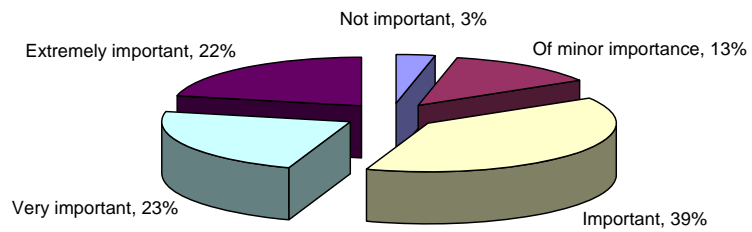
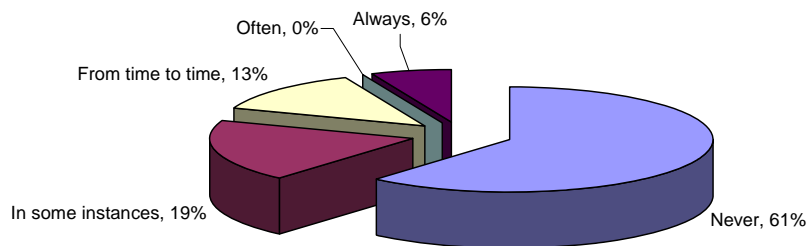


Figure 6.23 Importance of Psychometric and Brain Preference Tests.



The cohesiveness between members of the management team can further be enhanced by the use of a mediator. The respondents do not agree with this statement and only 3% use mediators on a regular basis while a further 26% use it from time to time as can be seen in figure 6.24. The respondents appreciate the role that a mentor can sometimes play in a venture to enhance cohesiveness and capacitate the management team with the transfer of knowledge and skills (see figure 6.25). The respondents are mainly investors in later stage ventures as can be seen in figure 6.5, with complete management teams, where the need for mediators and mentor are not that eminent.

Figure 6.24 Need for a Mediator.

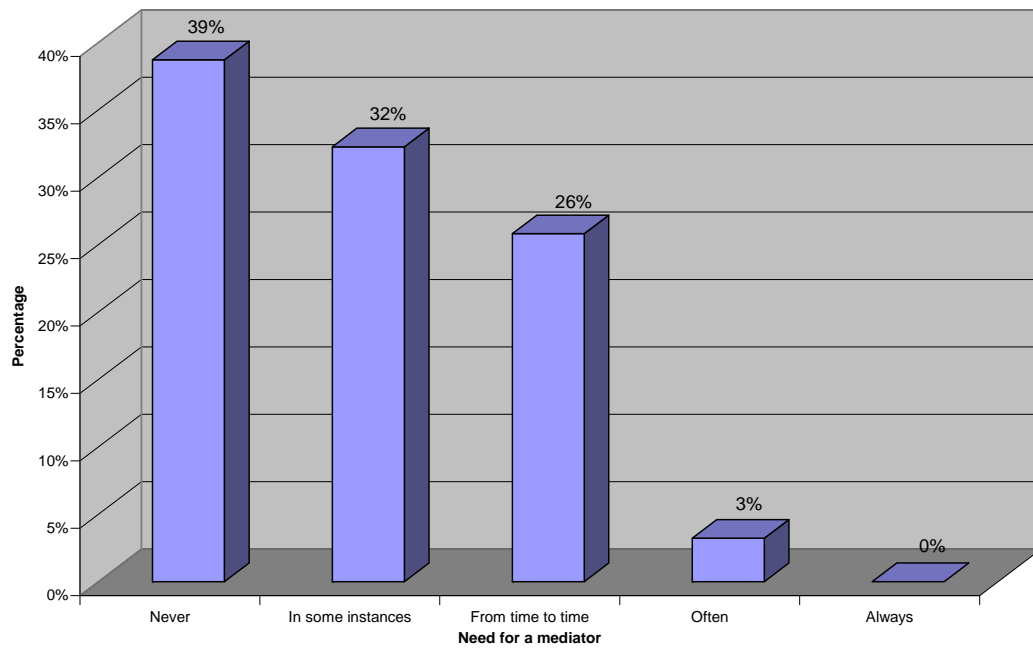
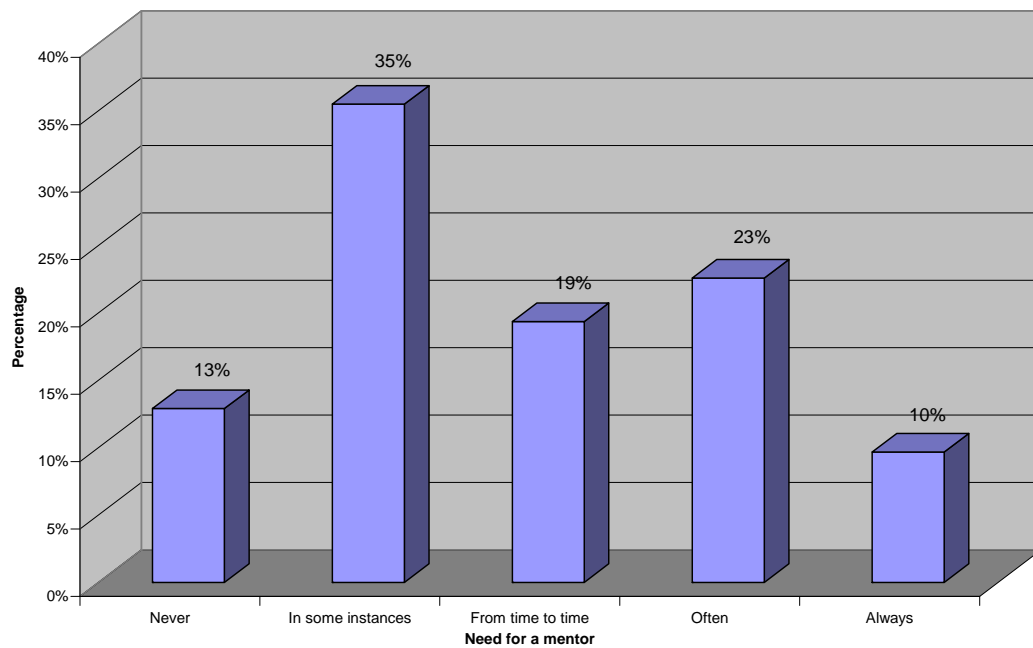


Figure 6.25 Need for a Mentor.



6.3.5 Investment.

The investment process does not only consist out of the provision of funding but involve important value adding activities which determine the success of the venture. The ranking of the findings in the South African research differs from the research done by De Noble, Ehrlich and Moore (1994:75) as can be seen in table 3.2. Monitoring financial performance, acting as a sounding board and monitoring operating performances are the most important activities in the South African research (see figure 6.2.6) whilst the interface with the investor group, obtaining alternative equity finance and monitoring financial performances, in this order, is seen to be the most important value adding activities for venture capitalist in the USA (see table 3.2). Obtaining alternative equity finance is seen as the least important value adding activity in South Africa while it is seen by the venture capitalist in the USA as the second most and by the angel investors in the USA as the sixth most important value adding activity. The South African investors market concentrate much more on the control and monitoring activities than their counterparts in the USA.

Figure 6.26 Importance of Value Adding Activities.

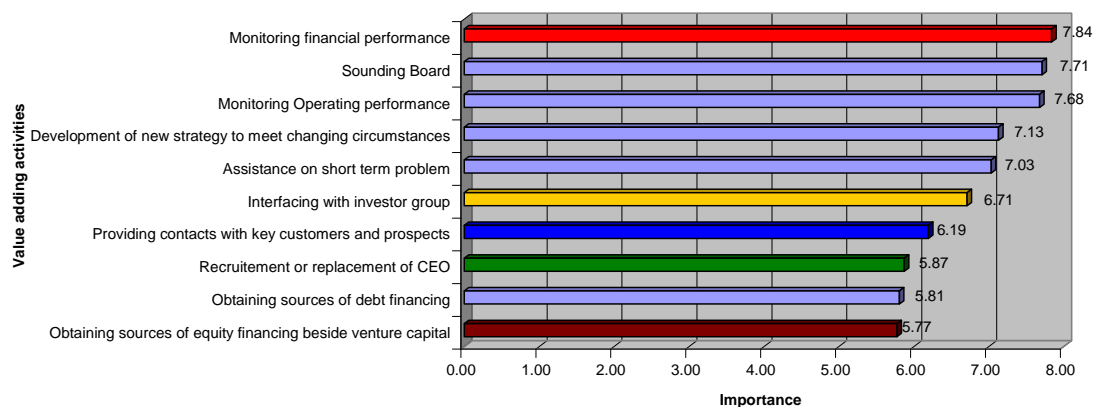


Table 6.2 Importance of Value Adding Activities.

	Ranking of value adding activities (1 = most important, 7 = least important)		
Value adding activities	Venture capital funded entrepreneurs - USA	Angel investment funded entrepreneurs - USA	Value adding activities in South Africa
Monitor financial performance	3	2	1
Sounding board	4	3	2
Monitor operating performance	5	5	3
Formulate business strategy	6	4	4
Assistance in short term problems	Not researched	Not researched	5
Interface with investor groups	1	1	6
Providing contacts with key customers and prospects	Not researched	Not researched	7

The importance of the monitoring and controlling activities is a clear indication that the investors in South Africa are more private equity investors than true venture capitalist and angel investors. The majority of the investments made are large investments exceeding R10 million while only 19% of the investments made are less than R2 million as can be seen in figure 6.27. The larger investments support the above statement regarding the nature of the investments made.

Figure 6.27 Average Amount Invested per Investor in a Portfolio Company.

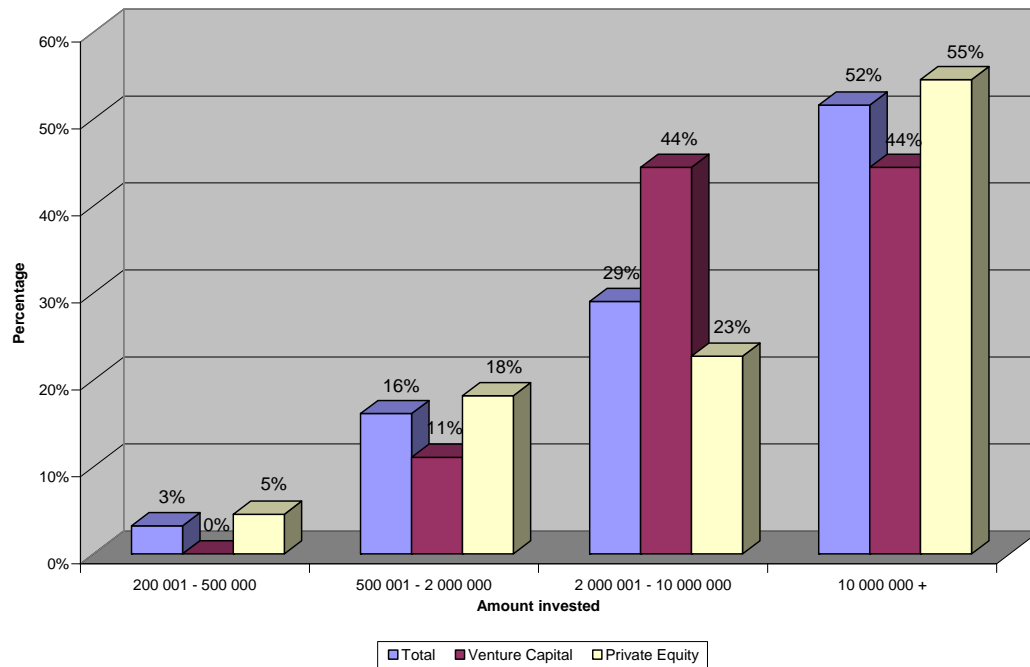
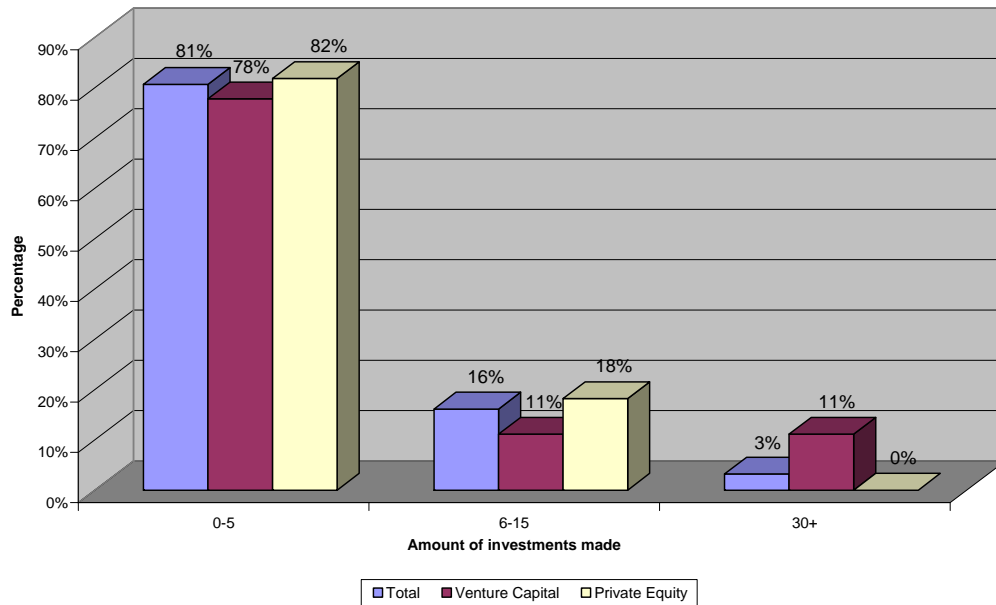


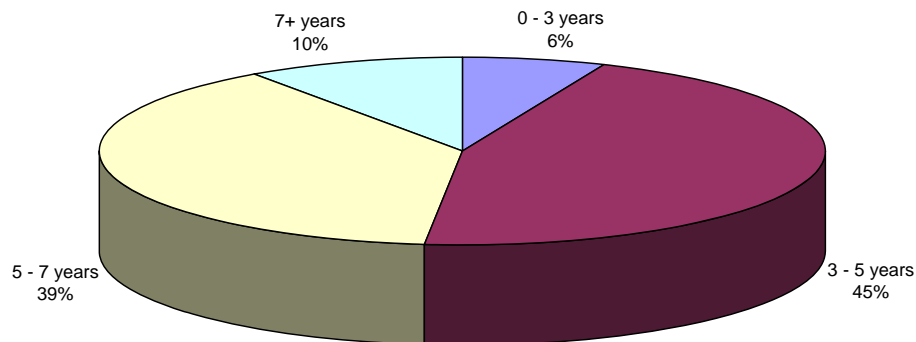
Figure 6.28 illustrates that the majority of the investors prefer to invest in less than 5 investments per year, while a small percentage are prepared to invest in 6 to 15 ventures per year and an even smaller percentage is prepared to invest in more than 30. The same tendency as in South Africa is to be found in the USA and Europe as can be seen in figure 4.12.

Figure 6.28 Number of Investments Made per Investor per Year.



Investments have a curing period that is normally expected to be 5 years and longer. The investment needs time to reach its optimum value before an investor should part with his investment. The majority of South African investors want to exit their investment before the end of year five, see figure 6.29, of which 6% part with their investments in a venture before the end of year three. The return on the investment increases the longer an investment is maintained as can be seen in figure 4.17 – 4.19.

Figure 6.29 Average Time before Exit.



A very high rate of successful ventures is maintained in South Africa. More than 60% of the investments made have an 80% and above success rate, as can be seen in figure 6.30. The high success rate is a factor of good control, see table 6.2 and the preference of investors are to invest in the industry known to them, see figure 6.31. The research done in the USA support this finding as can be seen in figure 4.22. Investment in the industry known to the investor enhances the returns achieved due to the fact that the investor is capable of and can be actively involved in the transfer of knowledge and skills to the management team. The high success rate is due to the nature of investment and investment stages that the investors are prepared to invest in.

The high South African success rate is not a true reflection of the total venture capital market due to the fact that the investors are mainly later stage investors where success is almost guaranteed. New venture investment rarely happens whilst the investors cover their risk through tangible securities taken. The results are therefore cluttered and the true success rate is disguised.

Figure 6.30 Success Rate per Investment Made.

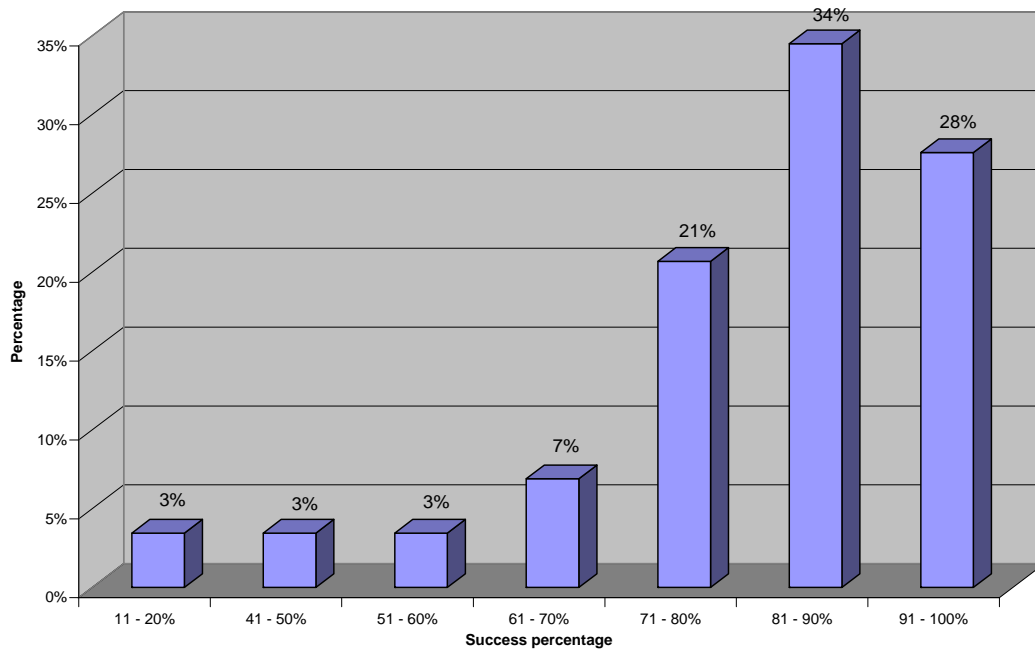
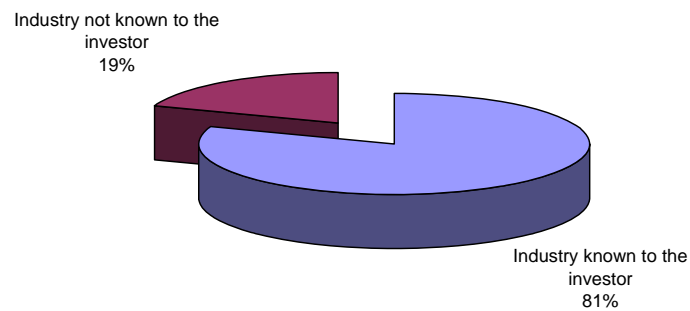


Figure 6.31 Investment in Industry Known to the Investor.



Investors tend to decline investments if the investment amount is too small or smaller than what they prefer to invest in (see figure 6.32). Opportunities are lost in this process and a good venture with a lower funding need can be ignored whilst it might be the best investment opportunity available. It is important to determine the value of the venture through the due diligence process and not only through the funding needed. Investors may also sometimes decline an investment if he/she can not get control of the board or get at least managing control through a 51% shareholding stake. The absolute need for control is not only a protection or a way to transfer risk, but may ultimately be labeled as “vulture capitalism” where the investor wants to control at all cost due to the financial powers available to him/her. The equity stake taken up by the investor should be a function of the expected return, within which the risk is factored in. This principle is normally ignored in the South African market as can be seen in figure 6.33.

Figure 6.32 Declining an Investment.

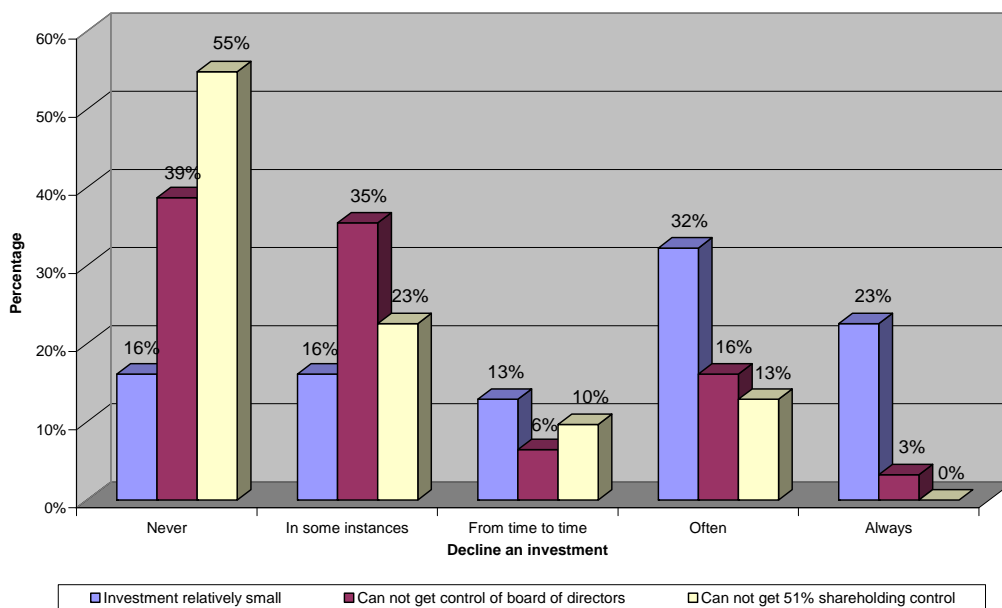
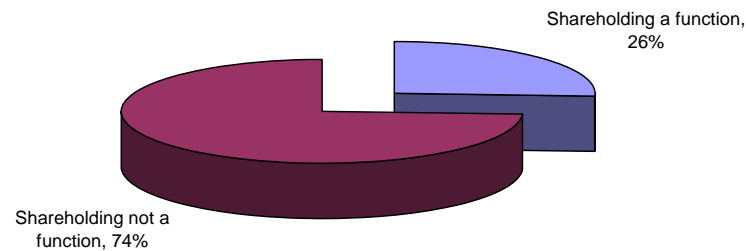


Figure 6.33 Equity Stake as a Function of Expected Return.



6.3 Conclusion.

The research population consists mainly out of private equity investors due to the under developed angel investor and venture capital markets in South Africa. Private equity investors as well as venture capitalists are predominately fund managers which is visible in the results of the survey done. A summary of the results of the South African survey is shown in table 6.3. Chapter seven will deal with the conclusion of the findings in chapter 6 after which recommendations for further studies will be made.

Table 6.3 Summary of the South African Survey Results.

Questions	Description	Paragraph Addressed	Result
4	Respondents.	Par 6.2.1, Figure 6.1	Private equity investors - 71%, venture capitalists 29%.
6	Investment stages.	Par 6.2.2, Figure 6.5 and 6.6.	The majority of the investments are made in the later stages of development of the venture. The earlier stages are not popular due to the perceived risk involve.

7	Investor's involvement.	Par 6.2.3, Figure 6.8 and 6.9	The two most important areas of involvement that the investor has is the role of investor/shareholder and non-executive director.
8	Average invested per investor in a portfolio company.	Par 6.2.5, Figure 6.27	The majority of the investments are large investments common to private equity and later stage investors.
9	Number of investments per investor per year.	Par 6.2.5, Figure 6.28	The majority of the investors to restrict their investment to less than five investments per year.
10	Own successful venture.	Par 6.2.1, Figure 6.2	Own successful venture 52%, no entrepreneurial experience 48%.
11	Source of funds.	Par 6.2.1, Figure 6.4	58% of the investors invest some of their own funds in the ventures being invested in.
12	Average time before exit.	Par 6.2.5, Figure 6.29	Investors are prepared to wait for the investment to cure although 6% of the investors want to exit in a period of 3 years.
13	Success rate of investments made.	Par 6.2.5, Figure 6.30	A very high success rate is maintained in South Africa. More than 50% of investments made have a better than 80% success rate.
14	Experience as investor.	Par 6.2.1, Figure 6.3	0 to 5 years 39%, 6 to 10 years 26%, 11+ years 35%.
16	Equity stake as a function of expected return.	Par 6.2.5, Figure 6.33	The equity stake is in most cases not a function of the expected return.
18 – 21	Investor's involvement in the venture.	Par 6.2.3, Figure 6.12 - 6.15	Investors tend to be more directly involved in the day to day activities of a venture in the seed, start-up and early stages of the venture's development than in the later stages. The investor's contribution in the earlier stages is critical for the success of the venture.
21	Investor's involvement in the selection of directors, CEO and management team.	Par 6.2.3, Figure 6.11	Investors reduce their risk through their involvement in the selection process, in order to ensure that capable people are appointed.
23	Investor's role in the board of directors.	Par 6.2.3, Figure 6.16	Investors prefer to be actively involved in the board of directors where the board renders a supportive role to the management team.
24	Investment in industry known to investor.	Par 6.2.5, Figure 6.31	Investors prefer to invest in industries known to them. The investor's ability to contribute to a venture is also higher if the investment is in the industry known to them.
27	Declining an investment.	Par 6.2.5, Figure 6.32	Investment will often be declined because the investment amount is too small, while an investment will in lesser cases be declined because the investor can not get at least 51% shareholding control or control of the board of directors.

28	External and non-executive directors.	Par 6.2.3, Figure 6.10	The non-executive director is seen to contribute valuable support to the venture and its management team, and is always appointed in 39% of the cases.
30	Value adding activities.	Par 6.2.5, Figure 6.26	Monitoring financial performance, acting as a sounding board and monitoring operating performances are the most important activities.
32	Excellent idea versus complete management team.	Par 6.2.4, Figure 6.17	The risk of an incomplete management team poses just too much risk for the later stage investor.
33	Brain preference / psychometric tests.	Par 6.2.4, Figure 6.23	The use of these test as an indication in the appointment of a management team member are rarely used.
35	Importance of a management team member's personality compatibility.	Par 6.2.4, Figure 6.22	The importance of personality compatibility is not seen to be important.
36	Importance of working cohesively.	Par 6.2.4, Figure 6.22	The success of a management team is determined by the team's ability to work cohesively.
37	Replacement of the management team.	Par 6.2.4, Figure 6.19	Investors are involved in the selection of the management team but rarely replace the management team in full.
38	Need for a mediator.	Par 6.2.4, Figure 6.24	The use of a mediator is not seen to be that important in a management team scenario.
39	Need for a mentor.	Par 6.2.4, Figure 6.25	The role of a mentor enhances the ventures ability to be successful.
40	Important characteristics of a management team.	Par 6.2.4, Figure 6.18	The most important characteristic that a management team must have is integrity followed by motivation, intellectual honesty and leadership ability.
43	Management team member's knowledge levels.	Par 6.2.4, Figure 6.20	Investors and shareholders will rather appoint a management team member with tacit than explicit knowledge.
44	Importance of different investment groups.	Par 6.2.2, Figure 6.7	All the investment groups have a role to play in the development of the venture with the venture capital group as the most important

The South African venture capital market is mainly a later stage investment market that discounts their risk through tangible securities taken in the investment process. Investments made are large amounts in well-established ventures with complete management teams where the investor's involvement is restricted to control and ensuring that the venture complies too the expectation of the providers of the funds. Most of the investors prefer to take control of the venture through shareholding and directorships with

the main intention to maximise their return. The South African market concentrates much more on control and monitoring as their counterpart in the USA. The USA market is a matured market where the investors will not be as involved in the day to day management of the venture as is the case in South Africa. The USA investors concentrate much more on the strategic management and assistance of a venture than the direct control thereof.

Venture capital is defined by Benjamin and Margus (2001: 7) as the business of building business, an aspect that is neglected in South Africa. The investors are mainly later stage investors that are not interested in the seed, start-up and early stage development of ventures. The creation of new ventures and the financing of such ventures as well as other SME's are neglected and in most cases ignored. Economic growth and job creation are neglected in the process.

Angel investors that prefer to be involved in the earlier stages of the development of a venture is not formalised in South Africa and exist only on an informal basis. The absence, or near absence, of angel investors restrict new business development, and therefore economical growth, in South Africa.

The investors in South Africa are mainly fund managers with little, if any, previous entrepreneurial or private sector experience that restricts the investors to transfer knowledge and skills to the venture invested in. The investor's main interest is the return on his investment.

In conclusion it can be said that the South African venture capital market as defined by Barlett (1988: 2) and Benjamin as well as Margus (2001: 7) is still an incomplete investment market that concentrates mainly on later stage investments through fund managers.

CHAPTER 7 CONCLUSIONS AND RECOMMENDATIONS FOR FURTHER STUDY.

7.1 Introduction.

New business development is one of the most important contributors to economic growth, job creation and economic prosperity of any country. The successful creation of new ventures is a difficult process with many risks involved. The reward of a successful venture is such that many investors are prepared to accept a certain level of risk in the hope of achieving high returns on their capital invested. Many different aspects contributing to the success of a new venture and specifically the importance of the transfer of knowledge and skills in the investment process, was researched. Venture capital investment in the broader term, including angel investing, venture capital and private equity investment, is important contributors to economical growth and prosperity. Venture capital is seen to be a very risky way of investment where the risk can be reduced through the active involvement of the investor in the transferring of knowledge and skills during the investment process. The investor is not only a provider of funds but also the provider of knowledge and skills to assist the venture to become successful.

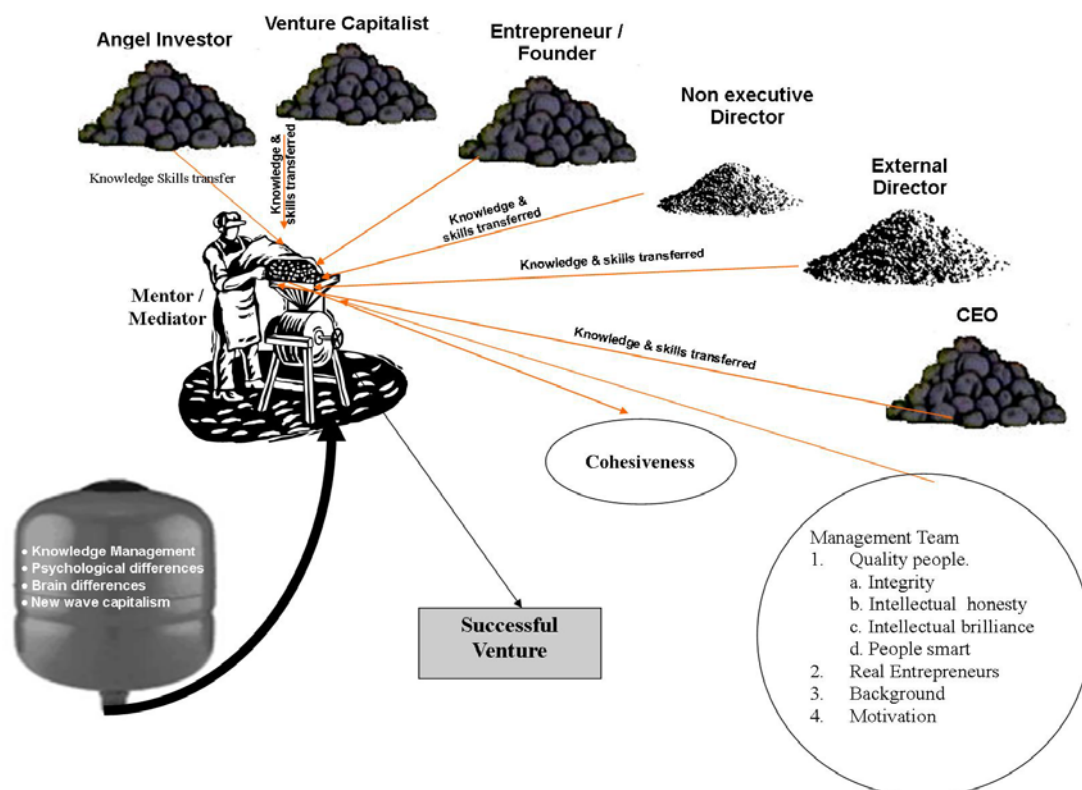
7.2 Conclusion

The main objective of this study was to determine the impact of the transfer of knowledge and skills by the investor to the investee on the success of the angel and venture capital investments, internationally and in South Africa. The venture capital and private equity market is a very young investment market in South Africa whiles the angel investors market, although it exists, is not formalised. Internationally and especially in the USA these markets are well developed and clearly illustrates the success rate of ventures in this country. The rest of the world followed in the footsteps of the venture capital markets in the USA, with the USA being the leader in this field. Venture capital is not a new way of the investment, not even in South Africa seeing that companies like ABSA Bank, Sanlam and Liberty Life was formed and funded in a true venture capital

manner. Research done determining the reason for success of investments in new ventures normally concentrate on financial aspects, product related aspects and marketing. The non-financial aspects determining the success of the ventures are seen by the investors to be important but are normally left to the management team to resolve.

The main objective is achieved and the research done supports the objective that the success of a venture is achieved through non-financial aspects that can be contributed to the transfer of knowledge and skills during the investment process. The literature research indicated that the investor's role entail much more than just providing funding where the transfer of knowledge and skills, "streetwise" knowledge, is determined in the success of any venture. Figure 7.1 summarised the important aspects that determine the success of the investments made.

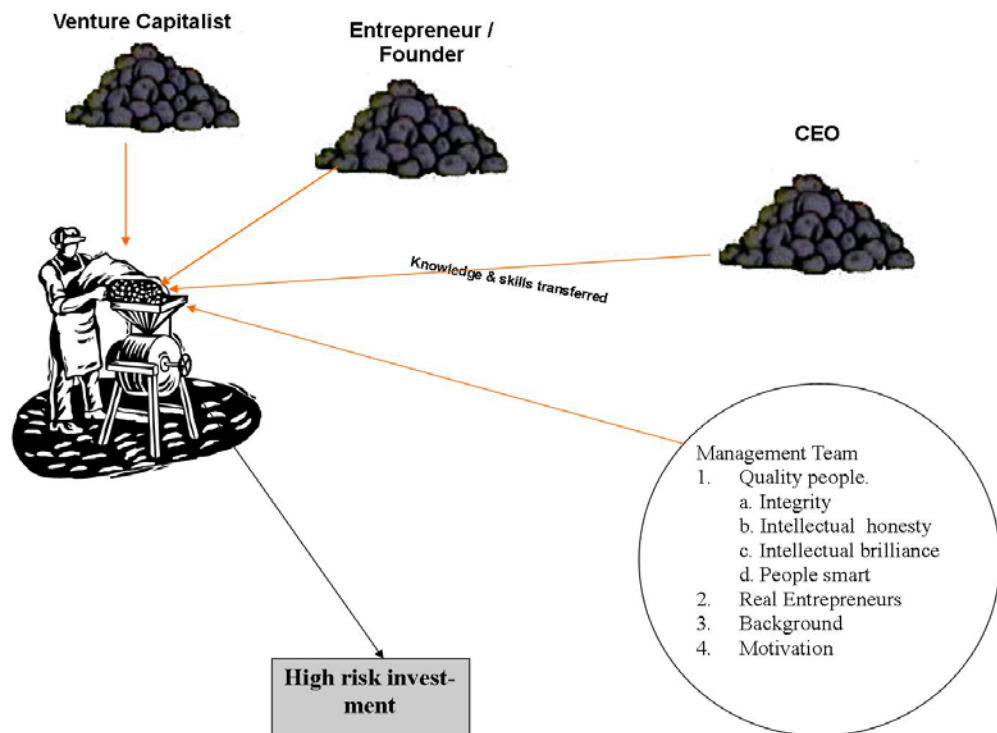
Figure 7.1 The Successful Investment Process.



The venture development process requires that the entrepreneur at first begins his new venture through the help of family and friends that believe in his project after which the angel investors, venture capitalists/private equity investors, commercial banks and merchant bankers get involved. Each one of these investors have a specific contribution to make in the development of a venture, lacking will lead to a higher probability of failure of the venture. The angel investors market is formalised in the USA but are lacking in the rest of the world.

The entrepreneurial knowledge of the investor and the involvement of investment funds, identifying the high returns in the angel and venture capital markets as a target, force the investor to invest in later stage investments rather than early or seed phases. The venture capital and later stage investors prefer to make less but bigger investments, later stage investments give the investor the opportunity to be involved as a shareholder/investor and as a non-executive director without being directly involved in other matters of the venture. The venture capitalist in the USA concentrates more on the support of the venture through their interface with the investment group, obtaining of equity finance, monitoring of financial performances acting as a sounding board, monitoring operating performances and formulation of the business strategy, while the South African investors concentrate more on the control of the venture than on the support functions. The high emphasis on control is a clear indication that most of the South African respondents are fund managers and not seasoned entrepreneurs. The investment risk increases as some of the important role players, as indicated in figure 7.1, are omitted from the investment process. The attractiveness of an investment is then based purely on the availability of an opportunity. The absence of the different role players creates a lack of knowledge and skills in the venture which could be detrimental for the venture. Figure 7.2 indicates the expected investment process when the investor and the entrepreneur do not appreciate the importance of transferring knowledge and skills to the new venture.

Figure 7.2 The High Risk Investment Process.



The ability of investors to transfer knowledge and skills is enhanced through the preference to invest in industries known to the investors. Previous knowledge of the industry helps the investor to make prompt, correct decisions and add value to the venture's management team.

A complete management team is preferred by all investors although many opportunities will go astray if the investor ignores the opportunity and only concentrates on the management team. The investor's ability to identify shortcomings in the management structure is an important value adding activity. The quality and ability of the management team can further be enhanced by ensuring that the management's personalities are compatible. Strong leadership and a mediator will enhance cohesiveness and the implementation of psychometric/ brain preference tests in order to use the managers in

the correct portfolios. The tendency in South Africa to get control of the venture leans to vulture capitalism that will lead to the entrepreneur losing interest and initiative. Shareholding should be divided according to equitable expectations.

The main objective was achieved and supported by the research done in the USA and South Africa. The effect of the transfer of knowledge and skills is further supported by the effect on the long term return. The transfer of knowledge and skills and active participation increases the expected IRR. The findings are also supported by the literature research done in chapter 2 and 3 indicating important elements needed to enhance the venture's chances of success. Transfer of knowledge and skills do increase the success of ventures as found by an Italian businessman, Carmelo Pistorio, operating in Singapore, who is an angel investor with hands-on entrepreneurial experience to guide his seed companies. Pistorio has a 90% success rate in the ventures in which he invested; far above the normal accepted average of about 20 to 40%.

Information was gathered through literature review and supported by recent research done in the USA and Europe. The information gathered in this study was evaluated and used in the formalisation of the factors determining the success of a venture. The gathering of the information and eventual evaluation confirms that the transfer of knowledge and skills are important factors determining the success of a venture.

The investor's role is not only one of funding, but also one of providing knowledge and skills to the venture and its management team. The marginalisation of the investor's role enhances the risk of investment in new ventures which has a detrimental economical growth effect in any country in the world. Especially for South Africa as an emerging economy, successful ventures are a prerequisite for sustainable economic growth and job creation.

7.3 Recommendations for Further Research.

The following recommendations from the research done in this study may briefly be outlined as follows:

Further research may be undertaken to formalise the angel investor/angel investing process for South Africa. The process needs to be researched and a model for the angel investment process must be established. In addition to this, guidelines for the transfer of knowledge in the investment process may also contribute to the success rate of new ventures.

Further research may include a survey of successful small to medium enterprises to determine the factors that made them successful. As an emerging economy South Africa needs new business and the success of establishing a new business must compete with developed countries such as America.

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ANNEXURE A

SURVEY QUESTIONNAIRE

SURVEY QUESTIONNAIRE:

IMPORTANCE OF KNOWLEDGE AND SKILLS TRANSFER IN THE VENTURE CAPITAL AND ANGEL INVESTING PROCESS

THIS PAGE ALLOWS ACCESS TO THE SURVEY QUESTIONNAIRE:

It will take about 5 to 7 minutes to complete the questionnaire.

After completing the questionnaire please submit by clicking on the SUBMIT button.

- [Private Equity, Venture
Capital and Angel
Investing Process](#)

THANK YOU FOR YOUR TIME!

SURVEY QUESTIONNAIRE: IMPORTANCE OF KNOWLEDGE AND SKILLS TRANSFER IN THE PRIVATE EQUITY, VENTURE CAPITAL AND ANGEL INVESTING PROCESS



Personal details:

1	Company name:	<input type="text"/>
	Respondent name:	<input type="text"/>
	Age:	<input type="text"/>
	Address line 1:	<input type="text"/>
	Address line 2:	<input type="text"/>
	Address line 3:	<input type="text"/>
	Area code:	<input type="text"/>
	E-mail address:	<input type="text"/>
	Telephone numbers:	<input type="text"/>
2	Do you want a summary of the survey results:	<input type="checkbox"/>
3	May we contact you if we have further questions:	<input type="checkbox"/>

Question 4: How will you classify yourself or your company?

Question 5: In which of the following market segments do you operate?

<input type="checkbox"/> Communication (Telecommunication)	<input type="checkbox"/> Information technology	<input type="checkbox"/> Electronics
<input type="checkbox"/> Biotechnology and medicine	<input type="checkbox"/> Energy	<input type="checkbox"/> Agriculture
<input type="checkbox"/> Consumer related products	<input type="checkbox"/> Transportation	<input type="checkbox"/> Industrial products
<input type="checkbox"/> Chemicals and materials	<input type="checkbox"/> Industrial automation	<input type="checkbox"/> Professional services
Other: <input type="text"/>		

Question 6: In which stage of investment are you involved?

<input type="checkbox"/> Seed capital	<input type="checkbox"/> Start up
<input type="checkbox"/> Early growth	<input type="checkbox"/> Established
<input type="checkbox"/> Later stage	

Question 7: What is your role in portfolio companies?

<input type="checkbox"/> Investor/shareholder	<input type="checkbox"/> Director
<input type="checkbox"/> Non executive director	<input type="checkbox"/> External director
<input type="checkbox"/> Chief executive officer	<input type="checkbox"/> Member of the management team
Other <input type="text"/>	

Question 8: What is the average amount (in Rand) that you would spend in a portfolio company?

Question 9: What number of investments do you make in a calendar year?

Question 10: Have you had your own successful venture before?

Question 11: Do you invest your own funds?

Question 12: What is the average time before you exit?

Question 13: What is the average success rate of investments made by your company?

Question 14: How long have you, as an investor been involved in venture capital or private equity investment?

Question 15: What is the average percentage shareholding taken up by your firm?

Question 16: Do you determine the percentage the percentage shareholding as a function of expected return on investment?

Question 17: What is the percentage shareholding that the founder/entrepreneur is normally left with?

Seed:	<input type="text"/>
Start-up:	<input type="text"/>
Early growth:	<input type="text"/>
Established:	<input type="text"/>

Question 18: How involved is your company in the matters of your portfolio companies during the seed phase?

Shareholders meetings:	<input type="text"/>
Directors level:	<input type="text"/>
Management level:	<input type="text"/>
Operational level:	<input type="text"/>

Question 19: How involved is your company in the matters of your portfolio companies during the start-up?

Shareholders meetings:	<input type="text"/>
Directors level:	<input type="text"/>
Management level:	<input type="text"/>
Operational level:	<input type="text"/>

Question 20: How involved is your company in the matters of your portfolio companies during the early growth?

Shareholders meetings:	<input type="text"/>
------------------------	----------------------

Directors level:	<input type="text"/>
Management level:	<input type="text"/>
Operational level:	<input type="text"/>

Question 21: How involved is your company in the matters of your portfolio companies during the established phase?

Shareholders meetings:	<input type="text"/>
Directors level:	<input type="text"/>
Management level:	<input type="text"/>
Operational level:	<input type="text"/>

Question 22: Are you or your company actively involved in the selection and appointment of:

Board of directors:	<input type="text"/>
The CEO:	<input type="text"/>
The management team:	<input type="text"/>

Question 23: What is the role of the board of directors in the portfolio companies that you get involved with?

<input type="text"/>

Question 24: Do you prefer to invest in companies that operate in the industry that you are familiar with?

<input type="text"/>

Question 27: Will your company decline an investment if the investment needed a relatively small amount:

	<input type="text"/>
if you cannot get control of the board of directors:	<input type="text"/>
if you do not get at least 51% of the portfolio company's shares:	<input type="text"/>

Question 28: Do you appoint external or non executive directors on the board of directors in your portfolio companies?

<input type="text"/>

Question 29: How important is the role of the external and non executive directors?

>

Question 30: Rank each of the following value adding activities of the board of directors in order of importance with 10 = the most important and 1 = the least important for your company.

1	Serving as a sounding board to the entrepreneurial team:	<input type="text"/>
2	Interfacing with investor group:	<input type="text"/>
3	Monitoring operating performance:	<input type="text"/>
4	Monitoring financial performance:	<input type="text"/>
5	Recruitment and/or replacement of CEO:	<input type="text"/>
6	Assistance on short term crisis/problems:	<input type="text"/>
7	Providing contacts with key customers and prospects:	<input type="text"/>
8	Development of new strategy to meet changing circumstances:	<input type="text"/>
9	Obtaining sources of debt financing:	<input type="text"/>
10	Obtaining sources of equity financing beside venture capital:	<input type="text"/>

Question 31: How important is the role of the external director in the role of mentor and sounding board?

Question 32: Will you invest in a venture with an excellent idea/concept/product and an incomplete management team?

Question 33: Do you do physiological and brain preference tests on the CEO and the management team before appointment?

Question 34: Do you appoint the CEO and management team according to the result of the above tests?

Question 35: How important is it that the investor, entrepreneur and the management team's personalities are compatible?

Question 36: How important is it that the investor, entrepreneur and management team work cohesively?

Question 37: How often do you change the management team that are presented to you by the entrepreneur?

Question 38: Is there a need for a mediator, to ease differences and combine different personalities, in the portfolio company?

Question 39: Is there a need for a mentor to guide the management team in the portfolio companies?

Question 40: Rank the importance of the characteristics determining the quality of the management team.

1	Integrity:	<input type="text"/>
2	Intellectual honesty:	<input type="text"/>
3	Intellectual brilliance:	<input type="text"/>
4	People smart:	<input type="text"/>
5	Leadership ability:	<input type="text"/>
6	Ability to build a team:	<input type="text"/>
7	Real entrepreneurs:	<input type="text"/>
8	Good business judgement:	<input type="text"/>
9	Knowledge, skill level and intelligence:	<input type="text"/>
10	Motivation:	<input type="text"/>

Question 43: Would you rather appoint someone in your management team that is a new graduate (explicit knowledge) than someone with experience (tacit knowledge) that is academically not well qualified?

Question 44: Rank the following sectors that play a role in the development of new ventures from the most (5) important to the least (1) important.

1	Family and friends: <input type="text"/>
2	Angel investors: <input type="text"/>
3	Venture capitalists: <input type="text"/>
4	Commercial banks: <input type="text"/>
5	Merchant bankers: <input type="text"/>

Question 45: Are you investing in ventures to:

General comments:

Click SUBMIT to store(save) the information

ANNEXURE B

SURVEY LETTER



Universiteit van Stellenbosch



University of Stellenbosch

Departement Ondernemingsbestuur
Department of Business Management

Dear respondent,

RESEARCH SURVEY

The success of private equity investment, where venture capital and angel investing is included, is determined by many internal and external factors. Research is required to maximise the success factor of these investments. Private equity investments are potentially a large contributor to economic and job opportunity growth in South Africa. The United States of America and to a lesser extent Europe is optimising this investment resource to maximise their economic and job opportunity growth. The South African government has identified these investment markets as important investment areas with the proposed tax relieves for venture capital investment and their involvement in the venture capital and private equity markets.

This survey is carried out as part of a masters research dissertation and has the support of the University of Stellenbosch (www.sun.ac.za, supervisor is Professor Johan van Rooyen (jvrooyen@sun.ac.za) and JP Fourie South - African Venture Capital Association (SAVCA).

The objective of the research is to contribute to the success of private equity (venture capital, including angel investing) in an emerging economy such as that of South Africa.

The following areas are covered in the research;

1. Ownership
2. Directorship (Internal and external)
3. Management.
4. The role of a mentor and mediator in the company.
5. The importance of a proper due diligence on the success of the venture.
6. Evaluation of the USA and European markets in the specific markets.
7. Evaluation of the South African market, compared to the USA and European markets.
8. The current development in the investment market in South Africa.

A summary or details of the survey results will be made available to you, should you require it. Please clearly indicate, in the questionnaire, whether you are interested in the information.

Please support the survey by giving me your valuable input. This survey can not be completed without your help!

Please click on the link below to access the survey questionnaires:

(Please be sure to click the SUBMIT button after completing the questionnaire otherwise the information will not be stored in the data base.)

Access to Survey questionnaire

Thank you for your time and effort.

Best regards,

Schalk Cadle
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